

PREFATORY NOTE

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Meeting of the Federal Open Market Committee

October 3, 1989

A meeting of the Federal Open Market Committee was held in the offices of the Board of Governors of the Federal Reserve System in Washington, D.C., on Tuesday, October 3, 1989, at 9:00 a.m.

PRESENT: Mr. Greenspan, Chairman
Mr. Corrigan, Vice Chairman
Mr. Angell
Mr. Guffey
Mr. Johnson
Mr. Keehn
Mr. Kelley
Mr. LaWare
Mr. Melzer
Ms. Seger
Mr. Syron

Messrs. Boehne, Boykin, Hoskins, and Stern, Alternate Members of the Federal Open Market Committee

Messrs. Black, Forrestal and Parry, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Kohn, Secretary and Economist
Mr. Bernard, Assistant Secretary
Mr. Gillum, Deputy Assistant Secretary
Mr. Mattingly, General Counsel
Mr. Patrikis, Deputy General Counsel
Mr. Prell, Economist
Mr. Truman, Economist

Messrs. R. Davis, T. Davis, Lindsey, Ms. Munnell,
Messrs. Promisel, Scheld, Siegman, Simpson,
and Slifman, Associate Economists

Mr. Sternlight, Manager for Domestic Operations,
System Open Market Account
Mr. Cross, Manager for Foreign Operations,
System Open Market Account

Mr. Coyne,¹ Assistant to the Board, Board of Governors
Mr. Ettin,¹ Deputy Director, Division of Research and
Statistics, Board of Governors
Mr. Keleher, Assistant to Governor Johnson, Office of
Board Members, Board of Governors
Mr. Stockton,² Associate Director, Division of
Research and Statistics, Board of Governors
Ms. Low, Open Market Secretariat Assistant, Division of
Monetary Affairs, Board of Governors

Messrs. Beebe, Broaddus, J. Davis, Lang, Rolnick,
Rosenblum, and Ms. Tschinkel, Senior Vice Presidents,
Federal Reserve Banks of San Francisco, Richmond,
Cleveland, Philadelphia, Minneapolis, Dallas, and
Atlanta, respectively

Messrs. Guentner and Thornton, Assistant Vice Presidents,
Federal Reserve Banks of New York and St. Louis,
respectively

1. Entered meeting prior to discussion of current monetary policy.
2. Left meeting prior to discussion of current monetary policy.

Transcript of Federal Open Market Committee Meeting of
October 3, 1989

CHAIRMAN GREENSPAN. Good morning, everyone. Would somebody please move the minutes of August 22?

MS. SEGER. I'll move it.

VICE CHAIRMAN CORRIGAN. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Cross, you've had a dull few weeks!

MR. CROSS. I'm not even going to report today!

MR. BLACK. That probably means he doesn't want any questions!

MR. CROSS. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Cross?

MR. HOSKINS. Where are we relative to our ceiling [on holdings of foreign currencies]? Do you anticipate our having to do more in the intermeeting period ahead in terms of raising the [\$20 billion] ceiling?

MR. CROSS. We are at just under \$1-1/2 billion below the ceiling. Whether it is going to prove necessary to request a further change in that depends very much on how things develop over the months ahead. But we do have \$1-1/2 billion which, if we share 50/50 with the Treasury, means that there could be a substantial amount of intervention--\$3 billion worth--before we would come up against the ceiling.

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. Sam, there were a couple of things that I thought didn't come through quite clearly in your report. First of all, the G-7 Communique said it looked like the dollar was out of line with existing fundamentals. I certainly disagree with that, but I guess one could debate that point. But what the Communique also said, specifically in follow-up language, was that the G-7 would consider it counterproductive if the dollar rose above current levels or fell sharply. In terms of exchange rate strategy, my understanding was that there was certainly no implication in there about a concerted attack on the dollar. You mentioned that the strategy was generally to resist upward pressure, but there were times repeatedly when there was a concerted effort to drive the dollar lower and then, as it ratcheted down, to hammer it when it even started to show any upward pressure from lower levels. So, I think it's a bit of a semantic issue to talk about resisting upward pressure when in fact it was a clear strategy to ratchet down the dollar. Even though there were not massive levels of dollars sold, that kind of strategy--especially when we've never participated in Far Eastern markets on a regular basis--in my opinion was just grossly destabilizing. I thought it was a scary event, and I can't see us condoning that sort of a strategy. I think it's potentially very, very dangerous.

MR. CROSS. Well, the words in the Communique were exactly what you said and exactly what I read in my statement--that a further rise or an excessive decline could adversely affect the prospects. I would say, though, that there is a very, very major difference between going in and hammering the dollar down in falling markets and resisting it when it is rising. We didn't always resist it immediately when it showed any increase; we resisted when it was rising and let the market take it down some. Obviously, the market knew that the G-7 was trying to guide the dollar down some. But the point I was making was that we did recognize and try to take account of, as much as we could, the risks that could follow if we really did go in and hammer the dollar down while it was falling, which we didn't really do.

MR. JOHNSON. Well, let me ask a question. Is there any kind of technical agreement within the G-7 on a targeted band on exchange rates now? I'm certainly not aware of any. And if there is, what is it specifically?

MR. CROSS. So far as I'm aware, there is none.

MR. JOHNSON. There is no quantitative understanding about ranges?

MR. CROSS. I am not aware of any target ranges that are in existence. While there were some months and months ago, I don't think those have any relevance at the present time.

MR. JOHNSON. Well then, how did you know where you were going?

MR. CROSS. Well, we were talking every day--

MR. JOHNSON. What was your objective?

MR. CROSS. Our objective was to curb the dollar's rise and to have it decline some. We did not want it to fall an enormous--

MR. JOHNSON. But where?

MR. CROSS. We discuss every day what to do for the following day. It had fallen a little from time to time; it did not fall in massive amounts on any day. We discussed with the others, based on the closing level in New York, say, on Tuesday, what might be a sensible target.

MR. JOHNSON. Just put yourself in the position of somebody in the market. If the market concluded that what the Communique meant was that the G-7 wanted a lower dollar, that is [not the same as] resisting [a rise] from current levels. So they're trying to figure out where the fundamentals are; what is the target that goes along with the fundamentals? It sounds like even we don't know. There is not even an understanding about where the dollar ought to be.

MR. CROSS. There is an understanding that the rise that had occurred was not helpful. And there is an effort to bring about greater stability and to reduce the dollar somewhat. But no one knows that you need to move the dollar down to XYZ point in order to assure

that it meets with these longer-term [fundamentals]. So the intention, as far as I'm concerned, was to try to take away some of this upward momentum and to let it ease off somewhat. But, as I say, it hasn't fallen all that much and we haven't driven it down that much. We're now at levels we saw in August--that's less than two months ago--and that we saw earlier in May. I'm sure that if the dollar were to show a further significant rise this approach would change.

CHAIRMAN GREENSPAN. Let me answer, Governor Johnson. The best way of defining what was involved is that it was not a range for the dollar, but how much the various governments would be willing to commit. I think the best way of describing the agreement is that there would be moderate intervention and if that intervention knocked the dollar down significantly, which it did, that was fine. But if it did not, there was no agreement to just use unlimited resources to break the market. That was an original proposal which had been shot down. And in a sense, rather than talk in terms of what was the ultimate goal, I think the more appropriate issue as to where the restraints were and what the guidelines were was the degree of resources that were being placed into the markets.

MR. JOHNSON. Well, since there was no notion on where the dollar should be but there was a commitment of dollars, what would have happened if the dollar had collapsed and yet you'd only spent a third of your commitment?

MR. CROSS. We would have stopped.

MR. JOHNSON. You would just keep spending it?

MR. CROSS. No.

MR. HOSKINS. Where do you stop?

MR. JOHNSON. But where do you stop?

CHAIRMAN GREENSPAN. That's why in various meetings the central banks that were involved in this insisted upon looking at what was going on in the secondary markets--so that any evidence of a cumulative deterioration would have induced a real pull back. It really wasn't country versus country. It was finance ministers against central bank governors. If you're having trouble finding out what the ranges are or what the policy is, [that is because] you're looking at a committee. They tried to get a consistent day-by-day scenario, but as Ted Truman put it, there were too many branches of possibilities. As they went day-by-day, the restraint or the criterion was the amount of resources that were available, not a particular target.

MR. JOHNSON. Well, if that's the case, I think it's even more dangerous than I thought it was when I first started this conversation. We spent \$400 million and we intervened five times in the market yesterday with the dollar down to around 139 for the yen and 1.87 on the D-mark, and yet we don't know where we're going.

MR. CROSS. We entered in for almost all of that after the dollar had moved up from that 139.

MR. JOHNSON. Well, up a fraction.

MR. CROSS. We knew of some points that were particularly sensitive in the market as the dollar got up close to 140 [yen] and we went in again in order to try to keep it from going through the 140 level. We didn't do enough to keep it from going through.

MR. JOHNSON. Hearing this description, I think there's a risk that risk premiums are going to continue to grow. With as much uncertainty as there is in here, you can imagine the uncertainty that might be out in the market if we can't even figure out what's going on.

CHAIRMAN GREENSPAN. That's not quite fair.

VICE CHAIRMAN CORRIGAN. You're shooting the messenger here, Governor Johnson! [Laughter].

MR. JOHNSON. Well, I realize there is a resistance to a lot of the [intervention] strategy here [among Committee members], but I think we ought to step up that resistance.

MR. BOEHNE. I'd like to pursue this conversation along a somewhat different line. If I were in the market and saw this kind of intervention--and the dollar has come down--one of the reasons I might think it would come down is that if governments are going to spend this kind of money, they must have a second act. And the second act might be some understanding as to some basic policy changes. So, my first question is: In these discussions about intervention, is there some kind of understanding that the intervention will be followed up with more fundamental changes in economic policy, whether on the monetary side or the fiscal side?

CHAIRMAN GREENSPAN. The answer is "no."

MR. JOHNSON. The market thinks so.

MR. BOEHNE. I think the market would think so, because most people probably would agree that intervention, except in rare situations, has a rather temporary influence unless it is followed up with something more fundamental.

CHAIRMAN GREENSPAN. Ed, that is true among academicians; it is not true among finance ministers. There is an belief now, particularly among the Japanese, that sterilized intervention can put the exchange rate where they want it.

MR. BOEHNE. Well, that leads into my next question; I think you touched on it. Is the United States leading the charge on this or is it more a consortium of finance ministers who are leading the charge and central bankers are acting as their agents? Or is there a lot of enthusiasm on the part of central banks? I'm just trying to understand.

CHAIRMAN GREENSPAN. There is no enthusiasm among any of the central bankers. I don't think even the Bank of France is enthusiastic. The two leading prongs are the U.S. Treasury and the Ministry of Finance of Japan. There has been a pulling and tugging on

this of rather large dimensions. My impression is that in the event this all fails and the dollar starts to creep back up this intervention effort will be abandoned. What we have to be careful about it is that as it becomes more and more difficult, they will want to increase [the amount of intervention] more and more. What we have been fending off, successfully so far, is pressure that was not too subtly brought forth before the G-7 meeting to bring the central banks into this whole game. In other words, essentially the G-7 would start to control monetary policy. And I think that was fended off pretty abruptly. There was a feeble attempt to put that in the Communique. That was knocked out very quickly before things got moving. Our problem, basically, is that at this stage we could probably as central banks--we could at the Fed--create a really big fuss about this. As you know, legally, the presumption is that the President, through the Secretary of the Treasury, has full control over the issue of intervention policy. It has never really been tested. We have always had a partial voice; in other words, when Messrs. Brady and Mulford started to talk about [a target of] 125 for the yen and 1.75 for the DM, I protested to a point where I suggested that they would pull the system apart. And I got that eliminated. So, they did have targets. The trouble is if we ever tried to get to those targets, we'd have the world's most awful mess on our hands. There is a limit as to what we can do short of confrontation. I don't think it serves either the Fed or the country to try to be actually up front and to bring this operation to an abrupt halt. I think we could do it. In other words, if that were our objective--forgetting all the secondary costs--I have no doubt that we could do it. I just think that it would be far better not to try that and, hopefully, keep this constrained at a level where the damage is minimal. I disagree with Manley on the issue of the secondary effects being scary; on the contrary, I was surprised at how minimal those effects were. Having seen an earlier version of intervention really almost kick over the bond market, I think in the last 10 days we got away with really minor results. I don't think we can depend on that continuing. I think that if we hammer at these markets, something will crack.

MR. BOEHNE. In your judgment, what will it take to get a message to our Treasury and the Japanese that-- I guess what I'm saying is: How long is it going to take for them to tire of this?

CHAIRMAN GREENSPAN. Well, let me start with the Japanese. It was very clear to me, walking into the G-7 meeting, that

He strikes me as a fixed exchange rate man, an interventionist who is willing to expend large resources to create changes.

he came over to me just before the G-7 meeting started and said if we can't get the Germans to join us we would like to join you, meaning the United States, in extensive exchange rate intervention. This is a different Japanese Ministry of Finance than ones we have dealt with earlier. With respect to the Treasury, it's basically Mr. Mulford with whom we are dealing and we have had philosophical and other differences with him on this and other issues for quite a while. We do have significant influence in that operation. In other words, it's not without possibilities. I don't know what the end result of this thing will be, but if the dollar all of a sudden starts to strengthen I will try as hard as I can to convince Secretary Brady that this is a futile effort, that the

markets are trying to tell us something, and that to fight against it is a rather fruitless task. Whether I will succeed, I don't know. Vice Chairman Corrigan.

VICE CHAIRMAN CORRIGAN. A couple of points: first of all, there's absolutely no question that a perception--whether it's reality or not--that the central bank is trying to beat down the dollar is a very, very dangerous thing; we would all agree with that. What may not be agreed to or perhaps understood is the amount of effort that has gone into trying to minimize the kinds of problems that could arise in the current circumstances both with our own Treasury and elsewhere. Maybe that hasn't been pristine pure or perfect in its execution but I think the thrust of the effort has been in that vein. But, again, the real question is the one that Ed Boehne started to ask and the real debate, it seems to me, should be on the threshold question of where we are. Obviously, Governor Johnson says in effect there are no imbalances. That isn't quite what you said but it's--

MR. JOHNSON. I don't say that. I recognize that there are imbalances. The question is whether they can be financed or not; nobody knows. The market is deciding they can and we are trying to second guess the world economy--

VICE CHAIRMAN CORRIGAN. I think that is really where the debate should lie. I don't think it's a question of intervention tactics per se. I think the real issue is the implications over time for where we are and where we are going with regard to the global economy and our national economy. In terms of some of the attitudes that go into this kind of convoluted point we're at, there are very sharp differences of opinion about the implications of the current situation and the outlook for the world economy.

MR. JOHNSON. But why should central banks be participating in this exercise? First of all, we've been making statements about price stability now to the point where I think we have almost been a "johnny-one-note" on that issue. And people, I think, are starting to believe us. For us to be countering that with this ridiculous approach just doesn't make sense; [it introduces] a potential doubt out there. If central banks continue to participate in this kind of strategy and show even a compromise on it, I think to some extent the markets are going to say this is a joke--in fact, they are balancing the goals of the current account versus price stability. Now, my position is well known in wanting to go gradually on this goal; but I sure don't have any current account goals ahead of our goals on price stability. And I think we'd be announcing to the world that we are at least equally concerned about bringing the international current account into balance as we are about conditions of domestic inflation.

VICE CHAIRMAN CORRIGAN. I don't think that's the question here.

MR. JOHNSON. But that is the question.

MR. ANGELL. That's the key issue.

VICE CHAIRMAN CORRIGAN. I agree that is the key issue but the question is: Are those goals compatible in any reasonable sense over even a 5-year period?

CHAIRMAN GREENSPAN. Can you hold it? Presidents Black and Hoskins wanted to get in here.

MR. BLACK. Mr. Chairman, most of what I wanted to cover has been covered by various people. I wanted to start off by saying that I think this issue is more important than any of the ones we have on the agenda. Despite the Japanese belief that sterilized intervention can have some permanent lasting effect, I don't really buy that. And I think this does put us into a dangerous position. As Sam indicated a while ago, we can drive the dollar down and the Treasury has a vested interest in that so as not to show a loss on its operations. You could say that we do, too, although I'm sure that that's not anything that would motivate us.

CHAIRMAN GREENSPAN. That is not the motive of Treasury.

MR. BLACK. Oh, I know that.

CHAIRMAN GREENSPAN. In fact, I just very recently have been arguing that the accumulation that we have to date does raise that issue; and this was before the Shadow Open Market Committee raised the test. They are only now becoming aware of that excess block of reserve currencies--that the foreign currencies that we have are a potential political threat whereas it was perceived that we all of a sudden [could] lose a part of our cash.

MR. BLACK. Well, the next point I was going to make was that I was sure you were making just that sort of argument and I wanted to commend you for having done that. I do think one issue remains and that is one that Governor Angell and Governor Johnson raised last time: whether this really can fall in our existing directive to counter disorderly conditions. To my mind, it might go a little beyond that. And I realize the [unintelligible] of the constitution is the Treasury [unintelligible] and I think you had to cooperate; I would support that. But I think it does behoove us to continue, as you are doing, to try to educate them that this path is fraught with a lot of dangers. At some point if we continue to get pressure from the Treasury to do this kind of thing I think we ought to at least take a look at the directive and maybe expand it--if we think that's appropriate--beyond disorderly conditions. I wouldn't want to go beyond that myself but maybe the Committee could. I realize you've been on the side of the angels in this and--

MR. ANGELL. That is correct.

CHAIRMAN GREENSPAN. I want to say that there's only one of them on which I have been on the side of.

MR. BLACK. Well, I was going to commend you but at the same time criticize the fact that we unavoidably and inextricably got drawn into it because of the Treasury's primary status in this thing. I would express the hope that this study we have undertaken could convince some of those who really don't know that much about it.

CHAIRMAN GREENSPAN. One of the things that I intend to do is to convey the substance of this meeting to Mr. Brady.

MR. BLACK. As I said, I knew you were on the side of the angels! Others may argue, but Wayne has had very close contact with angels and he says that that is exactly right! If there's anyone here who's equipped to speak for the angels I think he really is.

MR. GREENSPAN. President Hoskins.

MR. HOSKINS. Well, I won't go back to my objections to the whole policy because I've done that before. So, let me start someplace else, and that is that in this room it seems to me we have some concerns about whether or not we're going to be hanging together in terms of making decisions down the road. In the spring we had a dissent when we went to \$15 billion. Then we went to \$18 billion and I guess now we're at \$20 billion. It seems to me we had two dissents on the last go-around. So, I think that this issue is one that could divide this Committee and it's not the right issue to be fighting over. The right issue to be fighting over is price stability; and I think most people in the room agree with that. So, my only question to you--and I hope you do convey the feelings to the Treasury if that's really the sticking point because I think it's more important to have good relations on this Committee than it is with the Japanese, and I would cut it that way--how far are we willing to go in spending resources along this line? I'm sorry it's too far for me; but apparently we're not picking a limit. We may go on up and I think that would be bad for this Committee--you'll get bigger and bigger splits.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Well, it seems to me that we are pretty well agreed on the efforts to [discourage] intervention. I would say that we only have one factor that we can [use] and that is for you to make our viewpoint known as best you can to the Administration. My concern is that if we were to do something of a confrontational nature we would be forced or required to do things that we wouldn't want to do. I don't understand. If we were to back away, Manley, I don't know--

MR. JOHNSON. Let me say, Bob, that if that's the case, I think we're going through a silly exercise in approving limits. What's the FOMC meeting on this issue for? Why do we even care about it? Let's just turn over open market operations on foreign exchange to the Treasury. What are we going through this silly exercise for if we don't have something to say about it?

CHAIRMAN GREENSPAN. The point is we do.

MR. JOHNSON. But it is just--

CHAIRMAN GREENSPAN. No, that's not fair. We basically have something to say; maybe we've got 40 percent and they've got 60 percent, but it's not zero.

MR. JOHNSON. Well, we have an account in which we acquire exchange reserves and we are supposed to have authority over that account. As Bob Black said, we certainly we have a responsibility to serve as agent for the Treasury in their actions on foreign exchange. And the last thing I would want to do is question that authority. We can certainly do what they instruct us to do on their account; I would

never resist that. But acquiring exchange reserves on our account when we are totally opposed to the direction of policy that takes implicates us in the policy, I think. Now, I'm not for confrontation either. As a matter of fact, I consider myself to have been simmering a long time on this issue because I've generally been approving these things all along both at the Subcommittee level and at the higher FOMC level. I have never felt that dealing with disorderly conditions or resisting pressures in one direction or another was something worth fighting over. It was worth cooperating and maintaining this whole atmosphere of coordination and cooperation. But when I perceive that we're getting to a point where we are literally taking risks and we are moving in a direction counter to our whole philosophy, it seems to me that we've got to stand up and be counted here. This whole thing runs the risk of implicating us in something when we are out there saying we are standing for price stability. Now, I think we can have a debate here about how fast we want to go toward that goal; but it's going to take even longer if we participate in these kinds of activities. And I just think that at some point we have to give a clear message on what our point of view is on this. Continuing to acquire exchange reserves and exposure on our own account is really risky, especially given what I know about people over there running things at the Treasury. I don't think it's Nick Brady myself. I think you have a green-eyeshade person in David Mulford over there who doesn't know what he's doing. And I think it's very risky to turn over policy to somebody like that. I think Secretary Brady is capable of being brought around on this issue and maybe that's where [we should go]; I know the Chairman has been effective in talking to him before. I wouldn't be making these points if I wasn't worried. I think this strategy that we are pursuing is very risky and it makes us look bad.

MR. ANGELL. Mr. Chairman--

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I have some of the same concerns and I have raised them, in the fundamental sense, as we had these votes. But I think the Fed is in the fire and this is not the time when you fight the philosophical battle. It almost has to be resolved when you are not in the middle of the program. I guess the way I look at it is that if we were to get our backs up and refuse to participate at this point in time we'd, in effect, be embarrassing the United States in international policy circles. And I can't think of a dumber thing to do in a political sense. Even if we could defend it on price stability grounds, or try to, I think we would be painted with a different brush. [It would raise the question] as to why we have this arm of the U.S. government that has this kind of independence to pull that sort of thing. I think that's quite possible. Beyond that, in terms of market perceptions, I don't share your concern, Manley, about this intervention somehow really undercutting our credibility in a price stability sense. I think it would be far more damaging if the Fed refused to participate here and that became a cause [celebre]. Then market participants would be very concerned because of the split between the Fed and the Treasury and what that might imply in terms of U.S. economic policy.

MR. JOHNSON. What do we do if this continues?

MR. MELZER. Well, we have this study going on, but there comes a point where--purely from a financial point of view--looking at our balance sheet, we have more holdings of foreign currencies than is really justifiable in a financial sense. I guess that would define a limit. But I have some hope that if this proves not to work--and given the path the Chairman is taking--that the Treasury will change course. I have some hope that rather than through brinkmanship--

MR. JOHNSON. But what if they don't? If they don't, what are you going to do?

MR. MELZER. As I say, I think there could come a time; but I don't think this is the time.

VICE CHAIRMAN CORRIGAN. Manley, I think what we have to try to do is what the Chairman has been trying to do at one level and Sam and Ted [have been trying to do at their levels]. If you really want the worst scenario that we're all so terrified of, I'll tell you how you get it. That would be to advocate this and then have our 40 percent taken away so it's nothing. And then you would have your green eye shade guy running the shop.

MR. JOHNSON. I agree with that, but I can't buy the scenario in which that's going to happen in a credible way. Is the Treasury going to go to the Congress and say that somehow we are acting against the national interest of the country?

VICE CHAIRMAN CORRIGAN. It's not.

MR. TRUMAN. Absolutely.

VICE CHAIRMAN CORRIGAN. No, that's not the scenario.

MR. JOHNSON. But how is that going to work, Ted?

MR. TRUMAN. They have done it on several other issues.

MR. JOHNSON. I'm just asking: How is that going to be an effective argument?

MR. TRUMAN. They did it on debt strategy, so it's clear that the same man who did it to us on the debt strategy could; I don't think there's any doubt that he wouldn't do it on this one. And the trade issue is the gut issue in Congress.

VICE CHAIRMAN CORRIGAN. The point is that there is that danger; it raises the specter of what a fight will alter. That is the way this plays out. And if it's precisely that, that could precipitate the collapse in the dollar and the rout in the bond markets and the stock markets. That's what I think we have to be so careful of.

MR. JOHNSON. Well, as I said, I think confrontation has its risks too. You have two scenarios: one is that we confront the markets and we can say interest rates are going to be higher than what we forecast because the Fed is going to confront the Treasury. And they are going to resist with interest rates any attempt that the

Treasury makes on the dollar. Now, I'm sure that that would throw some heat into the markets.

VICE CHAIRMAN CORRIGAN. But that's a different debate.

MR. JOHNSON. But it certainly would [give] comfort on the price side.

VICE CHAIRMAN CORRIGAN. That's a different debate; that gets to the heart of the question of how do you get from here to there. It seems to me that's a different issue.

MR. JOHNSON. I don't understand. Look, the markets have a right to be concerned if the Treasury and the Fed can't coordinate policy. That's what it's all about here.

VICE CHAIRMAN CORRIGAN. The problem is we don't have any coordinated policy. We've got a lousy fiscal policy and a pretty good monetary policy. That's at the heart of the problem.

MR. JOHNSON. I don't disagree with that.

CHAIRMAN GREENSPAN. We have too many policy objectives and only one policy lever.

MR. JOHNSON. But I do think there is a risk for us that we're going to be implicated in talking out of one side of our mouth about price stability goals and yet agreeing to constantly flooding the market with dollars trying to get the dollar below where the fundamentals are taking it with relative interest rates. Now, you can argue about relative real interest rates--

VICE CHAIRMAN CORRIGAN. That is a different issue. The question in terms of the price stability goal is: How do you get from here to there? There are a lot of variables that go into that question of how you get from 4-1/2 percent inflation to 0 inflation.

MR. JOHNSON. You can still get there with Treasury pursuing what they have been pursuing, but at much higher interest rates--

VICE CHAIRMAN CORRIGAN. Well?

MR. JOHNSON. --and much lower growth, and even a recession. Maybe that is what we will pursue.

VICE CHAIRMAN CORRIGAN. That's the debate; that's the right issue: How do you get from here to there?

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Most of the questions I wanted to ask were already asked by Tom Melzer. But it seems to me that the United States has a strange [institutional] situation. Domestic monetary policy is the role of the independent central bank. International policy is the role--on a 60 percent basis, at least--of the Treasury. Mr. Chairman, I just wanted to ask a question but I think Jerry answered it already: Have you been faced with sort of a Hobson's choice in the sense of being involved in something that I think almost

everyone here is skeptical of--sterilized intervention--believing that we were better off over the long course of time maintaining that 40 percent, say, rather than [our] just getting out at this point in time for the reasons Tom Melzer noted? I think an important factor in waiting to see how long we want to remain a player is having some notion of how long this process will go on. It seems to me that it might be useful--I would hope useful from your perspective--when you go back and talk to the other people with whom you have to negotiate to indicate the degree of discomfort that many people have on the issue. But I agree with Tom; I just don't see at this point how we can back out of it. But I think we do need to have some notion of how long this will go on.

MR. HOSKINS. Or how much.

MR. SYRON. Yes.

MR. HOSKINS. Isn't that the question?

CHAIRMAN GREENSPAN. Part of the problem is that analytically we have been projecting a declining exchange rate for quite a while on the grounds that we've always perceived it as being out of sync and too high. And the failure [of the dollar] to do that has led us to temporize on this issue on the grounds that it would cure itself eventually--in other words that we might have to engage in this [unintelligible] just for the sake of appearances on the grounds that the markets would then take over and that [problem] would disappear. That hasn't happened. And that's what the problem is; and it's still a problem with respect to the forecast.

MR. HOSKINS. For coordination purposes I think we've always said--at least I've said all the way along that I'm willing to spend \$100 million here and there but not \$40 billion, \$20 billion of our own. We are beginning to talk about potential impacts on monetary policy and influences that are about to get negative on this Committee.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. It seems to me that the markets are beginning to recognize the Federal Reserve's commitment to price level stability. Mr. Chairman, you've certainly contributed to that and I think other members of the Committee have in regard to the one voice that we have in this area. But we can't have that commitment to price level stability without having a strong dollar. That is, a strong commitment to price level stability [requires appropriate] interest rate differentials and the dollar remaining strong. It just seems to me that we need to understand where our commitment is. And, Mr. Chairman, this discussion seems to indicate a very strong feeling in regard to the direction and the kind of policy we should engage in. But I think one can go so far as to say that the Treasury certainly would be dissatisfied to be without us. That is, the thought that we might pull out of this is indeed some force; and my dissent is in that vein. My dissent is to contribute to an environment in which the Treasury recognizes that it may not wish to go it alone. I agree it's best for us not to get out. But sometimes we have to act like we might get out in order to [achieve our objective]; and it's to your leadership that I entrust that we do it.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. Thank you, Mr. Chairman. I guess virtually everything has been said around the table. I don't have too much concern about the actual profits and losses that the System will sustain in terms of a rising dollar. I'm not terribly concerned about the price stability issue in the sense that with sterilized intervention I think for some long period in the future we can go about a price stability objective without much problem. What I am really concerned about, however, is bringing this issue to a confrontational stage outside of the confines of this Committee and the Treasury, because as soon as the public and the market perceive that there's a split I think we have the real possibility of a currency crunch that we will not want to face. We'll have to go together at that time.

CHAIRMAN GREENSPAN. As you know, it already showed up on the front page of The Wall Street Journal last Friday.

MR. GUFFEY. Yes, I know. I'd like to ask a question: How far can the Treasury go in the sense that they have a stabilization fund that is authorized by Congress? Is there no limit to what--

MR. JOHNSON. They can go on forever, Roger, when we keep warehousing their currency.

MR. GUFFEY. Well, they still have to get authorization for the Treasury to get dollars for us to warehouse.

MR. TRUMAN. No.

MR. CROSS. [They warehouse] foreign currencies with us, so they--

MR. GUFFEY. So there is a limitation.

VICE CHAIRMAN CORRIGAN. The problem there though, Roger, is that you give the Congress a choice. If you really do say you are going to give the Treasury some more money or you are going to balance the budget, which way do you think they're going to go?

MS. SEGER. Balance the budget, of course, Jerry.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I just have one comment. I was comforted by your statement that central bankers were lined up almost uniformly against the ministers of finance on that. Do you know how strongly they are arguing their position with their minister of finance counterparts as you are clearly doing in this country?

CHAIRMAN GREENSPAN. I'd say [it depends on] who controls this. The Bundesbank controls their exchange rate operation but they are pressured from the other side. I'd say that [unintelligible] was quite strong. The others I would say varied. Actually, has been unfriendly to this heavy intervention.

MR. JOHNSON. That's good.

CHAIRMAN GREENSPAN. And I assume as a consequence he would independently, or in support of--

MR. JOHNSON. What about the Canadians? They are not happy about it either, are they?

CHAIRMAN GREENSPAN. As far as I can tell. That would be my impression but I can't remember any real--

MR. TRUMAN. There is some. I think the Canadians have some differences of view within the central bank.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. I think we have talked about most of the issues. Clearly, you are in an awkward position. Just as one person around the table, I think the worst thing this Committee could do is to leave you hanging, given the awkwardness of where you are. Despite where we are on the fundamental policy issues and the difference with the Treasury, my question is: Given the situation that we are in, how can we be the most helpful to you as a Committee in this very awkward predicament that you find yourself in?

CHAIRMAN GREENSPAN. Well, let me find out whether or not the discussions with Messrs. Brady and Mulford on this help or hinder-- meaning whether or not the real deep-seated concern of this Committee induces them to be antagonistic or conciliatory. At the moment, I think it is frankly somewhat useful to have some rumbling of a minor nature at this stage because if it ever was to break then I would be concerned what would happen to the markets. But I think professional notions of discontent are not adverse provided they do not, for example, get into an Allen Murray front page article in The Wall Street Journal that the Federal Open Market Committee is revolting against the Treasury on exchange rate policy. And they are prepared to do that because that little thing they put in last Friday was much stronger than the reality of it was. So, that's a story that's sitting there ready to explode.

MR. BOEHNE. It probably will be in The Wall Street Journal next Monday, given the minutes to be released this Friday afternoon.

CHAIRMAN GREENSPAN. It may be.

MR. BOEHNE. I would think that Manley and Wayne better take a walk.

MR. JOHNSON. Well, as a matter of fact, I am going to be out of town. I'm going to be hiding out.

CHAIRMAN GREENSPAN. And I'll be in Moscow already--

SPEAKER(?). Maybe you'll be safe there.

MR. BLACK. May we all take off that day, Mr. Chairman? I'd really like to take off. Well, Monday is a holiday.

MR. JOHNSON. Yes, that's what I mean.

MR. SYRON. Columbus Day.

MR. BLACK. It'll be in the paper Tuesday, then.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I just want to say two things, primarily because I've been one of the people concerned about the strong dollar--not because I don't like strong dollars on the face of it--but because I've been concerned about the impact on our manufacturers' ability to produce or to export. But having said that, I don't believe the way to get the dollar down is to bomb it through intervention. I think the best way to do it is to deal with it in a monetary policy way even though the [unintelligible] said we don't believe in that, I do. In terms of Manley's concern over the possible market impact of this bombing effort, I think the reason we haven't seen it yet is that there are many people in the markets--maybe not in New York but in other parts of the markets--who really do think that there will be some monetary policy follow-up to this bombing. And if that does not occur in the next couple of weeks, then I think we're going to get the bond market impact etc., in spades. So you can write that down as woman's intuition speaking. Thank you.

CHAIRMAN GREENSPAN. I trust that ends our conversation? Does anyone want to make a last comment on this?

VICE CHAIRMAN CORRIGAN. Can I make the last comment?

CHAIRMAN GREENSPAN. Okay.

MR. SYRON. You can approve his transactions.

VICE CHAIRMAN CORRIGAN. I want to come back to this price stability issue. Obviously, that is the overriding goal for central banks. But I think we have to be a little careful about how we articulate that goal. If we articulate it in a way that creates or reinforces the perception that we can get from here to there in a costless, painless, way I think that can be very, very dangerous. And it's in that context that I worry about large current account deficits. I certainly don't view them as a goal, as I'm sure you know, Manley.

MR. JOHNSON. Sure, but--

VICE CHAIRMAN CORRIGAN. The question--if I can just finish--is whether the presence of current account deficits in excess of \$100 billion in perpetuity are compatible with an orderly and relatively painless ability to reach that goal of price stability.

MR. JOHNSON. And all I'm saying, Jerry, is that I don't know; I don't think anybody knows. It's a debatable issue. But to try and say beforehand that the dollar has to be at some level that some committee decides--

VICE CHAIRMAN CORRIGAN. That's a different question.

MR. JOHNSON. But it's not; it's the same.

VICE CHAIRMAN CORRIGAN. It's not.

MR. JOHNSON. A committee is a group of people.

CHAIRMAN GREENSPAN. Can I just stop here? This actually is a legitimate discussion, but not for this section. Let's leave this for later this morning and then resurrect it because it really gets into the fundamentals of the monetary policy debate. With some fear and trepidation I request the ratification [of the foreign currency transactions]. Would someone like to--

MS. SEGER. What happens if they are not ratified?

MR. CROSS. Ted's salary for the next 4,000 years--

CHAIRMAN GREENSPAN. Is there a motion on it?

SPEAKER(?). So moved.

SPEAKER(?). Second.

CHAIRMAN GREENSPAN. Without objection, hopefully?

MR. JOHNSON. Well, since I dissented [before] I don't know how I could--. How do I vote in favor of previous transactions?

MS. SEGER. Just abstain.

MR. TRUMAN. Maybe the General Counsel can speak to this, but isn't the issue here that he has done his job within the guidelines and the Committee is ratifying the transactions?

MR. JOHNSON. I think Sam has done his job very well.

CHAIRMAN GREENSPAN. That's what you're voting on.

MR. JOHNSON. Okay.

MR. ANGELL. He's done it too well.

MR. BLACK. What you are saying, then, is that it was the wrong job in your view?

MR. JOHNSON. Yes. It was very good in mechanics, but--

MR. BLACK. But it is the wrong job.

MR. BOEHNE. That's what we--

[Laughter]

MR. JOHNSON. All right. Well, I certainly want to make sure that that is the way it's written and the way it's understood.

MR. TRUMAN. Virgil [Mattingly] is nodding.

MR. MATTINGLY. That's all that you'd be doing, Governor.

MR. JOHNSON. What does the sentence say again--in terms of what we're voting for?

MR. ANGELL. Yes.

MR. CROSS. Approve the transactions that I have already done.

MR. JOHNSON. Well, how about the manner in which you conducted the transactions? Really, that's a different statement.

MR. CROSS. No, it's the matter of the money.

MR. HOSKINS. It's an obligation we have already passed [on].

MR. JOHNSON. Yes, but I voted against that.

MR. TRUMAN. Yes, but he does [operate under] certain procedures in the Authorization and Directive and the question is whether he followed the guidelines and procedures.

MR. JOHNSON. But I abstained on the warehousing [vote] as well.

MR. TRUMAN. I understand that.

MR. CROSS. That's a different issue in my opinion.

MR. TRUMAN. The issue is whether the transactions have been carried out consistent with the Authorization and the Directive; it's the same thing as for the domestic operations.

MR. MATTINGLY. It's the same as the vote of directors of a bank ratifying loans made by the bank. The loans are [already] made.

MR. ANGELL. Okay, here's what I'm going to do. I'm going to vote on the affirmative on this one because this has only to do with what has taken place. I dissented in regard to the Authorization, which was a proper dissent. So, I'm going to make that distinction, Manley. You do what you think.

MR. JOHNSON. I'm still trying to understand what this is all about.

MR. ANGELL. Well, in other words what we're doing now is saying that we did transactions. [The question is whether] they were authorized. In other words, are they approved?

MR. KOHN. The guidelines [that] the Committee has passed by majority vote--

MR. SYRON. The Committee passed by majority--in other words it is ratifying.

MR. JOHNSON. Okay, is that the way it reads?

MR. CROSS. My understanding is did I act within the authority authorized and provided for by the Committee even though I

recognized that certain people didn't agree or did not favor the way that was--

CHAIRMAN GREENSPAN. I think that's the reading.

MR. JOHNSON. As long as that's the way it reads, I agree that there is no problem.

VICE CHAIRMAN CORRIGAN. The analogy, I think, is that any time someone dissented on monetary policy grounds they would have to dissent on Mr. Sternlight's operations.

SPEAKER(?). It says "ratified."

CHAIRMAN GREENSPAN. That's true.

MR. TRUMAN. Okay, then you're fine. "Ratified" is the word that is used in the minutes.

MR. JOHNSON. Okay.

MR. TRUMAN. I'm not quite sure what it means; maybe we can get the lawyers to write us a memo.

MR. BOEHNE. I'm not asking.

CHAIRMAN GREENSPAN. I agree that there have been no objections. Mr. Sternlight.

MR. STERNLIGHT. Thank you. This is going to be an anti-climax! [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Sternlight? President Parry.

MR. PARRY. You said that you think the markets are anticipating further easing of some magnitude in the near term?

MR. STERNLIGHT. Of modest magnitude. I think there is an expectation, on balance, that the greater likelihood is for some easing down the road. If I drew up a central point consensus, something within a few months would probably capture it.

MR. PARRY. I bring this up because the Bluebook seemed to say the opposite--that [the market] does not now appear to be anticipating any near-term change of policy. I think it has implications for what might happen to market rates relative to the choices we make. So I just want to--

MR. KOHN. My judgment would be, President Parry, that if the market had to bet whether policy would go one way or another they'd bet that policy would more likely be eased than tightened. If you look at the term fed funds markets and fed funds futures and things like that, they don't really have much ease built in there. On the other hand, surveys such as the money market services survey do show a little downtick by the end of the year of maybe a quarter of a point. So it's a little; I don't think they have much built in there. It's

essentially flat with maybe some bias towards ease before the end of the year.

MR. FORRESTAL. Peter, do you think that bias is based on domestic considerations or foreign exchange issues?

MR. STERNLIGHT. I think it's a mixture of both, President Forrestal. Those who have that expectation anticipate seeing a bit more softness in business. But they think the foreign exchange factor certainly would be working that way too.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. I have a question not with regard to Peter's report on the operations but on the seasonal borrowing program. We basically hear about the borrowing within [unintelligible] rather high. And I'm not sure that fundamental underlying conditions are that different. It's easy to believe that people are perhaps using it, hopefully, advantageously. I just raise the question: Are we going to take a look at the use of the seasonal program before we get into next year?

MR. KOHN. We could certainly do that. That request has been made elsewhere in the System. Governor Angell has asked that same question. The seasonal borrowing is about what it was last year. So this is really the second year--

MR. KEEHN. At this point, Don, or--

MR. KOHN. Seasonal credit is a little higher than it was, but the spread is a little wider than it was. For the October 5th period last year seasonal borrowing was \$433 million; I don't know what will come out this year.

MR. KEEHN. Well, I think you're right. It seems to me it complicated the operation of the Desk on the way up and it's likely to complicate it on the way down. If people are using it for different reasons [other than] seasonal borrowings, I think it makes sense to take a look at it.

CHAIRMAN GREENSPAN. Any other questions for Mr. Sternlight at this time?

MR. HOSKINS. Just a minor one. Would we have done outright purchases if we hadn't had the intervention?

MR. STERNLIGHT. Oh, I think it's likely. The foreign exchange intervention wasn't adding as much as at some earlier points in the year but it was still adding fairly substantially. So, without that factor, we would have had to be doing some outright as currency in circulation was increasing.

MR. HOSKINS. Would that cause you any concern?

MR. STERNLIGHT. I wouldn't say it was a problem at all in our execution of operations. As a mechanical factor, we're amply well informed about the extent of the foreign exchange intervention and we just fold that in as a reserve factor in our planning of operations.

MR. HOSKINS. I just meant the substitution of the currency in the portfolio for coupons and bills.

MR. STERNLIGHT. No, I wouldn't say it's any problem in that way.

CHAIRMAN GREENSPAN. Can I have a motion to ratify the transactions of the Desk since the last meeting?

MR. JOHNSON. So move.

MR. KELLEY. Second.

CHAIRMAN GREENSPAN. Without objection. Mr. Prell, would you bring us up to date on the economic situation?

MR. PRELL. I'll try, Mr. Chairman. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Prell? Governor Johnson.

MR. JOHNSON. You mentioned that you expect some stimulus to the housing market but you are forecasting weakness in investment. Earlier, in previous FOMC meetings, you had said that declines in long-term interest rates stimulated investment in the housing market. Yet this hasn't seemed to occur. How long do you expect the lags to be after a decline in long-term interest rates before you see something in the investment in housing? You mentioned that the level of houses for sale was revised up. But I don't see any pickup in housing. And nondefense capital goods orders, excluding aircraft, seem to be at a lower level in the third quarter than the second quarter. I just see nothing out there that points to a pickup in capital spending and yet we have had this decline in interest rates.

MR. PRELL. I don't think we expect to see any dramatic interest rate effect in the trend of capital goods outlays. The lags there are too long. The [interest] elasticity is too low. We didn't really think that was going to move that series around very much. It's true that the orders trend, as I suggested, has not been especially strong of late. If you start dissecting the data and you take account of declining computer prices and so on, I think there is a sound case for expecting relatively moderate growth in real equipment outlays. And that's what we have in the forecast. We don't have an acceleration; we have a deceleration in the forecast.

MR. JOHNSON. Okay, I agree with that, I think. But what you're saying, though, is that this decline in long-term interest rates hasn't had a stimulative effect on this.

MR. PRELL. I don't think it has had a large effect, no. We haven't had a large enough change in interest rate levels to greatly alter businessmen's assessment of the profitability of investment over the long run. On the housing side, we have lowered our third-quarter forecast for real construction outlays. We were disappointed by the August housing starts. While the average in the past couple of months has been up a bit, it hasn't been dramatic by any means. A lot of that weakness has been in the multifamily sector; that's a very

volatile number. But the single-family starts in August also were a shade on the weak side. What we think is happening, though, is that we see some pickup in housing demand as manifested in existing home sales. And in new homes sales, the information from surveys about consumers' perceptions of home buying conditions has moved in a favorable direction with the decline in interest rates. We're expecting a modest boost to overall economic activity in the near term, this quarter, from residential construction. But that's a small sector. And despite the secondary effects that it can have on consumer expenditures and so forth we don't think it's going to provide a tremendous thrust to the economy. We do look for a positive number, though, in the fourth quarter.

MR. JOHNSON. I want to follow up on one last thing that I was talking about yesterday in the Board room when we were discussing [unintelligible] and I still want to try to understand this. You indicated then at the beginning of your presentation the need for some slack to get inflation down further in the economy. But I'm still trying to understand conceptually how that works to some degree. If monetary policy maintains nominal demand at potential output or at the full employment unemployment rate--say it maintained nominal demand consistent with potential output growth--is the need for slack because of the rigidities in the system? Does the adjustment process cause you to get more inflation mix than a real mix temporarily?

MR. PRELL. I think that's the case. If you had super rational people who perceive that all of a sudden monetary policy was on a track that was going to hold nominal aggregate demand expansion in line with the trend rate of real output growth, then expectations would change and wage bargaining would revolve around that kind of expectation. You could have an instantaneous downward adjustment in the rate of inflation without any significant cost in real output. Of course, there are contracts and other impediments so that even if expectations adjusted dramatically--

MR. JOHNSON. Okay. I want to understand what you're saying, though. Is it that even if we bring nominal demand in line with potential output, that actual output has to slow for a while relative to potential because of the contracts [and other] rigidities in the system? Okay, that's the--

MR. PRELL. I think you'd have a hard task to bring nominal aggregate demand expansion down immediately to that noninflationary level. I can't envision that happening without an enormous jolt to the system.

MR. JOHNSON. Yes, well I can't either. But I'm still trying to get--

MR. PRELL. But if there were no inflexibility in the form of contracts and so on and if you had absolute credibility--if you could announce today that you are pulling on to this track and everyone believed you--then presumably everything would flow through and real effects would be minimal.

MR. JOHNSON. Everybody understands that we have nominal demand that is greater than that; that's why we have 4 or 5 percent inflation in the market. But if you were to work nominal demand down

gradually in line with potential output and you maintained it there, I guess I would have a little trouble understanding why you would necessarily have any inflationary experience.

MR. PRELL. Well, I think you put your finger on the appropriate facets of the system here that impede that kind of frictionless movement toward lower inflation.

MR. JOHNSON. As I say, if you were to lower nominal demand--just lower it, even if it's currently above potential output--why doesn't that lead to some slowing in the inflation rate even though the real economy might be slowing but still not performing relative to potential?

MR. PRELL. At this point we feel the economy is, in a sense, overemployed. In that kind of situation the competition for resources tends to put upward pressure on wages and prices. And until we develop a bit more slack, we think that's the direction in which things are going to tend to drift. We've been generous, in a sense, relative to what the models would tell us. We have not really taken a hard view that we're below the natural rate and that there are tremendous acceleration forces here. We have rather modest acceleration in the forecast. But the historical evidence is reasonably compelling that in the short run there is this kind of trade-off and you don't get the frictional movement to lower inflation rates without any output loss.

MR. JOHNSON. Well, I think the historical record does show that if you reduce nominal demand there is a mixed effect--that you get a little of both.

MR. PRELL. Right, precisely.

MR. JOHNSON. The more flexible the markets are, the better the mix.

MR. PRELL. Well, that's why we are being reasonably optimistic. We think perhaps there is some greater flexibility. We think there is also some residuum of fear here about loss of employment and so forth that may not have existed in earlier years, but that workers are aware of because of the turmoil in the '80s and the exposure to international trade,

MR. JOHNSON. I'm just saying that, given all that, it's still not clear to me why the economy can't grow around its potential rate while you're restraining demand even though the mix does [unintelligible]. I think that's a central debate.

MR. PRELL. Sure. This is not something we feel we know absolutely. But we're hard pressed to explain what we have been observing without some sense that, as the economy got tighter, that exerted some inflationary pressure. You could play some games here in guessing what inflation expectations were at various times during the last several years and make that consistent with the pressures in the labor market in terms of the unemployment rate level not having been a substantial explanatory factor. But it looks to us that, as we got down into the 5 to 6 percent unemployment rate range, there was some pressure on wages and prices.

MR. JOHNSON. I don't disagree.

MR. PRELL. So the question is: How do you unwind that? If you could bring about a sudden powerful expectational change, that might help to minimize the need for any loss of output in order to move the inflation rate back down. But otherwise we think there are going to be some frictional costs here.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I'd like to ask two questions related to the near-term strength of the economy. Based upon the statistics that we now have for the third quarter, do you think there is much of a chance that the actual growth rate was in the 3+ percent area? And related to that, you have a very substantial decline in nonfarm inventories. Is that just what is happening as a result of aircraft? I see aircraft exports are up and are very strong.

MR. PRELL. You're talking about the fourth quarter, right?

MR. PARRY. Third and fourth, [unintelligible] inventories.

MR. PRELL. Yes, the fourth-quarter inventory picture is muddled by the aircraft deliveries and gyrations in oil inventories that we inferred will occur because of a surge in oil imports recently. So there are those technical considerations. Basically, we have underlying that a rather moderate rate of inventory accumulation. On third-quarter growth, 3 percent or 3-1/2 percent is certainly within our confidence interval. At this point, looking at the labor input, a number in the two's looks like a better guess. But I know there are others who have looked at the data and come up with higher numbers. This is our best guess at this point with a lot of data missing.

CHAIRMAN GREENSPAN. If there are no further questions, I think it's time for us to do a tour de table. Who would like to start?

MR. FORRESTAL. I'll start it, Mr. Chairman. Let me say at the outset that I'm very pleased that the staff has extended the forecast through 1991; I think that does give a longer-term and more strategic focus on policy. With respect to the national economy, Mr. Chairman, we think that the Greenbook is about right for the next few quarters in terms of real GNP. We don't have any basic disagreements there. Also, our outlook for inflation is a little closer now to the Board staff's than it was at the last meeting. We've seen some improvements. Having said that, I think that we've been helped, obviously, by some special factors along the way, and I'm not sure that those are going to continue indefinitely. But more importantly--and perhaps where we might have some slight disagreement with the staff--is that we think the unemployment number may be a little lower than the Board staff's number; and that suggests to me that pressure on wages, as Mike has indicated, might begin to appear. We've had good numbers, as we've been observing, right along. These compensation gains have been smaller than we might have anticipated. But I do sense that there may be some deterioration in labor costs. We've had an increase in strike activity in 1989, which perhaps suggests a bit more militancy on the part of unions. Also, as the

fear of recession begins to wane, there may be more of a tendency on the part of business to accommodate some of the labor demands that I think might come along. I put that together with what I see in our own District with respect to the labor situation--I think things are tight--and that's where I see the pressure. That all suggests to me that it's going to be difficult to make much progress on inflation this year. Our forecast would suggest that some further tightening along the road is going to be necessary if we are going to get the inflation rate down lower.

Turning to the District, things have turned around a little; deceleration of economic activity has about come to an end and there's much more optimism among people generally. In other words, the concern about recession has abated. Construction activity remains particularly soft--both residential and office building activity. We do have some better activity on the industrial construction side, which is stronger in our District than anywhere else in the nation. And on the housing and real estate situation generally, we're hearing quite a lot of concern expressed about properties being put on the market as a result of the thrift insolvencies. People are afraid that as these institutions come on the market there's going to be an overhang, which will affect the market adversely. Automobile inventories remain a significant problem in our District. They are much higher than in the rest of the nation even though recent auto sales have been better. There is an interesting development in the textile area. The textile producers have been doing very, very well in terms of their sales but they are very concerned about imports, which are up about 11 percent from a year ago. Domestic demand for their goods has offset the danger of the imports but they're afraid that as domestic demand begins to slacken off, as they think it might, the imports will begin to affect them adversely. And I think this is significant because they have been very, very aggressive, as you know, in lobbying for protectionist legislation. I can't help but note that Representative Jenkins from the State of Georgia has assumed a higher profile in the Congress; he has been the one leading the charge for protectionism for the textile industry. So that's a bit worrisome, I think. I have just one other observation and that is that oil exploration and production in Louisiana are picking up; the number of offshore rigs has been increasing since April and that reverses a decline earlier in the year. Natural gas is also doing well. In agriculture the picture is mixed because there apparently has been either too much rain or too little. In our case, recent heavy rains have been a negative factor in many areas of the Southeast. But in general, Mr. Chairman, things are looking better in the Southeast on average than they did at the time of the last FOMC meeting.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. Thank you, Mr. Chairman. I think the tone of my report is probably going to be a little different from some others. The economy in the West currently is expanding at a healthy pace, and growth actually appears to have strengthened a little since our last meeting. Improvements in trade and service activity account for much of the recent strength we've seen. Apparel sales are reported to be strong and, of course, toward the end of the quarter there were quite strong sales of autos. We've seen good growth in tourism activity throughout the entire area. Construction, both residential and nonresidential, and real estate activity are strong in California.

Nevada, Washington, Oregon, Hawaii, and much of Idaho, although some slowing in home sales recently has appeared in southern California. Reports of weakness are focused, as they have been for the last several meetings, in Arizona and are associated primarily with construction. The Northwest is actually booming. I don't think there's any word that would be more appropriate. California-style bidding wars on single-family homes have become common in the Puget Sound area. Manufacturing firms throughout the Northwest plan to expand employment facilities and equipment. Now, in two hours the contract at Boeing will expire; 43,000 workers in Seattle and I think 12,000 in Wichita and 1,700 in Portland are covered by that union. But the chances look less than 50 percent that there will be a strike; it requires a two-thirds vote. At this point, if there is not a strike, I would assume that that strength would continue for the foreseeable future.

CHAIRMAN GREENSPAN. Are they voting today?

MR. PARRY. I don't know if they vote today, but the expiration of the contract occurs today at 10:00.

CHAIRMAN GREENSPAN. I heard something about their voting.

MR. PARRY. That could be, but it does require a two-thirds vote for a strike.

At the national level, the economy--to us at least--appears stronger than at the time of the last meeting. We've revised our estimates of third-quarter growth and now expect an increase of around 3 percent, which is somewhat different from that in the Greenbook. Also, I wouldn't be surprised to see stronger growth in final demand than projected in the Greenbook, especially in 1990. Quite frankly, looking at a lot of private forecasts, I see more centered in the area of 2 to 2-1/2 percent than I do under 2 percent at this point. If the growth does not slow as rapidly as projected in the Greenbook, then it seems clear that upward pressures on underlying inflation will persist.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Mr. Chairman, on this give and take, the New England economy is far from booming. The slowdown that we are in the midst of continues. It's not cataclysmic but it does seem steady. Interestingly, the earlier declines in the southern New England states--the big states such as Massachusetts and Connecticut--have now spread to the three northern New England states. There are a variety of factors: a quite poor tourism season, absolute declines of employment of a substantial magnitude, particularly in the construction area and also in manufacturing. In the case of manufacturing, I think that's a bit of a spillover from the slowdown in manufacturing in Connecticut and Massachusetts. In the case of construction, it just reflects overbuilding and a lot of excess second homes on the market. With respect to our manufacturers with whom we have contact, we get an interesting pattern. We tried to separate out what they tell us about the national economy from the regional economy and we get a very distinct difference in responses. With respect to the regional economy, everyone is really quite pessimistic; but in talking about the national economy, while no one is what we would call

euphoric or expects a runaway boom, the general response we're getting is that they expect a rather moderate and steady [growth], with some adjustment to the capital spending levels, but not a great one. There is not a great concern about inventories on their part. In retail activity within the District we see some significant problems, with the beginning of some inventory problems there. Labor markets are generally mixed. The agreements and settlements that have been reached generally have been well behaved although there are still substantial pressures at the low end of the labor market. At the higher end of the labor market things really have been softening quite a lot.

As far as the national economy goes, we have been generally comfortable with the Greenbook forecast with two caveats: (1) the Greenbook does have the saving rate declining, but we question whether it might possibly decline even more and consumption come up somewhat more; and (2) we have a concern about the pattern of wages. This is reflected in other things that have been said: whether in the employment cost index, particularly when one starts to disaggregate and look at what is unionized and what is nonunionized, there really is a dramatic change in that decomposition over time; and whether in the future, particularly if the national economy remains relatively robust, we might not have the kind of good behavior we've had in that area. Overall, we think the risks are about evenly balanced between the economy growing too fast or starting to slow too much, although we don't see any signs really of cumulative softness. I will finish by saying, as you indicated earlier when we were discussing the foreign currency issue, that before very long we're going to be in a situation where we have to decide as far as inflation goes just what we want to accomplish and in what kind of time period--what constraints we feel are on us and how the mechanisms work. Thank you, Mr. Chairman.

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I find myself in a little different position from the first three speakers. We really haven't changed our view of the economic outlook very much from what we had last time. The Greenbook projections seem reasonable to us; the staff always does a good job. I don't think I will ever understand how Mike Prell is able to answer so many questions so well! But since there is some onus on us to say how we differ, I would say that our best guess is that the downside risk is a little greater at this point than the upside risk, for a couple of reasons. First of all, I don't think we have yet seen the full effects of all the tightening that we have undertaken over the last year and a half. Secondly, a lot of the improvement that the Greenbook projects is based on the external sector and that, in turn, has an underlying assumption that the dollar is going to continue to depreciate at a rather steady rate. That's certainly a plausible position, but I think one can make some case that there is certainly more than a small possibility that the dollar just may not decline for reasons that we don't well understand. I don't think we fully understand why it was strong before we started intervening; it may well be that that strength is going to resume, particularly after we are out of the market. If that were to be the case, then real net exports and real GNP might come in a bit weaker than what the staff is projecting. On the inflation side, I found the staff's efforts to estimate the magnitude of the effects of the projected depreciation of the dollar extremely helpful but rather

disturbing, because even with these alternative projections we didn't show much progress on inflation through 1991. But again, we find ourselves in a rather unique position in that we think inflation may do better than the staff thinks. I feel rather uncomfortable with that because I remember--

CHAIRMAN GREENSPAN. I assume by that you mean down?

MR. BLACK. We think we will have less inflation than they projected. The reason I feel uncomfortable with that is that over time I think most of our System policy errors have been made by having been too easy rather than by having been too tight. And the outlook is dependent to a large extent on what I think is an unusually high degree of credibility that policy now enjoys. My feeling is that we probably have a higher degree of credibility now than we have ever had. And I think your statement in response to the Neal resolution did a lot to strengthen that. So, I'm a bit more optimistic on this than I have been. But I hope that doesn't translate into the wrong kind of policy for the Committee because I'm not ready at this point to relinquish the reins and say that we have this battle won, by any means.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. My views have been deviating a bit from the Greenbook in recent months and the deviation has grown. In terms of the economy, looking at the latest statistics and our own internal forecast and talking to business people around the District and elsewhere, I'm somewhat more optimistic about the outlook for real growth going forward. It looks to me like the economy, all things considered, is in remarkably good shape. And I expect that's going to continue. On the price side, too, I'm more optimistic in the sense that I think we have an opportunity to make more progress against inflation than the Greenbook envisions. I say that in part because of the course of monetary policy over the last 2-1/2 years, but also in part because business people I talk to are clearly reporting an abatement of inflationary pressures. That has been going on for several months despite the fact that there are many tight labor markets in our District; that doesn't seem to have been translated into wage pressures. I can only presume that concern about job security and the well known international environment--where foreign competition has been so very important--have served as restraining influences. I must say, having given that optimistic assessment, that I hate to go back to an old and somewhat unhappy topic but I do think this is all jeopardized by the course of the dollar, should it continue to decline. I think that would back up very quickly into deterioration in the inflationary situation and outlook and, ultimately, into the growth outlook as well. So I think there are some very serious risks there.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Well, I think the bearishness in New England is contagious; it's moving down the Atlantic coast. There clearly has been a shift in sentiment in my District away from one of optimism toward more concern about the economy. That is particularly true in the real estate business. Residential construction is very soft and, looking out over the next several years, it's likely not to strengthen

a great deal. Just looking at the underlying demographics, I wouldn't be surprised, for example, if a good year for housing starts might be two-thirds of what we have been used to in recent years. There is some pessimism in the manufacturing area, partly because of what has been happening to the dollar. The retailers are very cautious on inventories: inventories aren't going anywhere; they are essentially flat. People in capital spending still have fairly good back orders and I think are feeling good. Nonresidential construction is quite weak in New Jersey and Delaware; Pennsylvania tends to lag those states and we're going through an office building boom which I think will leave us in a glut position. I think we clearly are in a slowing position. With the national economy perhaps growing 2 to 2-1/2 percent this year, I would guess measured GNP in our District would be about flat. The unemployment rate, which has been well under the national average and still is under the national average, is nonetheless rising. It's still tight at the entry level and that, too, I think will carry forward given the demographics. But it is beginning to loosen up further up the ladder.

As far as the national economy goes, I think there is this dichotomy between what I'm seeing in my District and the national economy. It seems to me that the Greenbook is about right. One point, however, is that the change in the composition of demand, as shown in the Greenbook, does seem to have some implications for risks. Essentially, what we have is a move away from exports and a move away from capital spending in that we're counting on consumption and, to some extent, housing. I have some doubts about housing picking up and that leaves consumption. So it seems to me that we could end up with significantly less growth and perhaps even more growth. But my sense here is that the change in the nature of the composition probably leads us to a slightly greater risk on the down side going out into 1990, given the mix of output that we have had over the last year.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. Mr. Chairman, the overall situation, particularly as it relates to the Midwest, is largely consistent with a pattern that has been developing over the past several months--namely, moderation in many sectors. It is not in any way a sense of deterioration, but a tendency [for activity] to come down toward a level more consistent with our forecast. This moderation is particularly true in the heavy manufacturing part of our economy. For example: orders for the large trucks, Class A trucks, have slowed very considerably; orders for heavy construction equipment are down substantially; and some categories of machine tools are also off. Offsetting this, construction activity in the District continues to be pretty strong, stronger than the national numbers. Certainly, the automotive sector is difficult to read. I agree with Mike's categorization; I think the strong sales level in August that was carried over in September is largely for the 1989 [models] and is in anticipation of the substantial price increases for 1990 cars. Also, there are very heavy incentives on the 1989 models. As a consequence, dealers are selling out of their inventories and the order level from the dealers to the manufacturers I'm told recently has all but collapsed. As a consequence, the auto production schedules have been reduced substantially in the fourth quarter and the reductions planned for the first quarter of next year are even more substantial than that. So, anybody who is dealing with the auto sector is beginning to

take on a fairly bearish tone. In the agricultural area, the news is good. The harvest has started and we are anticipating good production on both corn and soybeans--not record crops, but substantially higher than last year. And our expectation is that, within the District, the USDA estimates of production are probably a little on the low side. On the price front, it's hard to get a good sense of where prices are going, at least from the reports I get. The Chicago purchasing managers' index came out earlier this week and the price component of that was at 50. I think that's reflective of the comments that I hear: some prices are up and some prices are down, but there's no decided trend one way or the other. On the wage front also there is no change. The settlements, in my view at least, continue to be quite constructive and not indicative of the wage pressures that you might expect. On net, I think the economy is moving along on a constructive but moderating trend. Not unlike the Greenbook, I think the outlook for the balance of this year and, indeed, the early part of next year is assured, but I'm beginning to get concerned as to what a continuation of our current policy may mean as we get further out into next year.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. Mr. Chairman, on the national picture our view would be pretty well along the lines of the Greenbook. We would not find anything about which we would have serious disagreement. As several others have pointed out, the forecast of inflation running through 1991 remains quite troublesome--certainly to me.

Looking at our District, it's very difficult to come up with adjectives to characterize what is going on. If I were an optimist I'd say we were having modest growth. If I were a pessimist I'd say it has turned very sluggish. Not knowing which I am, I'll try to describe a few of the elements. Where we had had some strength in manufacturing, those gains are slowing. The slowdown in electronics seems to be in line with expectations. In petrochemicals, inventories have been building and prices have been soft, with a result that several plant expansions either have been delayed or canceled. Retail sales have shown modest improvement with the exception of auto sales, which had been stronger and now are showing declines in many areas. Two of our weakest sectors, energy and construction, have begun to show small gains; but residential construction continues weak as does agriculture--both cattle and crops. The statistical data continue to show what I would say is modest growth. We have had rather extensive discussions over the last couple of weeks with various businessmen and others in our District. The attitude has changed, even in Houston. Growth seems to have leveled off there as it has [in Southern Texas]; and they were two particularly strong areas. The way that they are characterizing the situation is that they think our economy either has stalled or is shortly headed for a stall.

MS. SEGER. Is that because

MR. BOYKIN. That could be a factor!

SPEAKER(?). He's back.

MR. BLACK.

MS. SEGER. I thought he supported all expenditures that went into that area.

MR. BLACK. Well, I'm talking about

MS. SEGER. Oh, excuse me.

MR. BOYKIN. Well, a considerable difference--

MR. KELLEY. Approximately the same magnitude.

CHAIRMAN GREENSPAN. President Guffey.

MR. GUFFEY. The Tenth District economic conditions continue to improve slowly; I think they trail the national improvement. Nonetheless, improvement does show in retail sales, which were up over a year ago with inventories, we're told, well in line. With respect to [agriculture], the good news is that the drought has been broken, although crop estimates for the spring-planted crops are a fourth to a third below what would be an average crop. The bad news is that the rains have been so excessive that [farmers] are going to have a hard time getting the milo bean and corn out of their fields. As a result, I'm not sure what their conditions will be. But farm land values have continued to increase; in our last quarterly survey they were up over the three categories, roughly 2 percent over the quarter before, and that's eight consecutive quarters in which those land values have improved. The OPEC agreement to raise its production ceilings had very little effect on oil prices, but the drilling activity has increased modestly most recently. The rig count is about 259 in the District, about 5 percent below a year ago; but it is improving on a month-to-month basis. Most of that exploration is for gas; they have found a big gas field over in eastern Oklahoma and Texas which is being exploited apparently by some of our drillers who are going south and going to help your economy, Bob. Construction activity has been mixed, to be sure; nonresidential construction has increased from our last meeting here, whereas residential construction has fallen off.

With regard to my view of the national economy, I would accept readily the Greenbook forecast; I think it's appropriate. There are some within our own Bank who believe that forecast is a little stronger than they would project. But my own view is that it's about on track; given the underlying assumptions, I think it's a good forecast and one we ought to be happy with.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. The District hasn't changed much since I reported last time. We are continuing to have very high operating levels across almost all industries. We specifically targeted capital expenditures this time to see if the presumed slowdown was occurring and at least from the anecdotal [evidence] the answer to that is yes. Most of the firms we surveyed have orders to carry them through next year but there is a clear slowing in the order books for producers. We still have a couple of geographic areas in the District that are really quite strong. The Columbus area is one of them. We are seeing wage pressures there. Service-type industries will be looking at 6 percent increases in wages. But overall, we haven't seen a major change. Just to put it in perspective, Ohio is at about 4.8 percent

unemployment and I believe Pennsylvania is around 4.3 percent. So, we've got pretty robust economies but they're not expanding at rapid rates. And I think both [unintelligible].

In terms of the Greenbook, we have very little disagreement with respect to the longer-term outlook for real growth. Of course I'm disappointed, as everyone else is, with respect to the inflation prospects. In light of the discussion this morning and the alternatives shown in the price forecast, we seem to be working against ourselves. When we tried to bring down the dollar it cost us a half a point out there in 1991, if I read the chart right. So it seems to me that that's an issue that we have to grapple with at some point along the way. I'm not sure I'm ready to grapple with it today after this morning's discussion, however. That's all I have to say.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. The pattern in our District is the same as I've been reporting. We have had sluggish employment growth all year both in nonagricultural payrolls and in manufacturing, and that pattern continued in the most recent period. The only manufacturing sector that showed any growth was chemicals. There was particular weakness in electrical equipment: Whirlpool laid off 850 in Portsmouth, Arkansas; GE has announced layoffs of about 800 coming up in Louisville; [unintelligible]. Having said all that, though, I think we also have had very slow labor force growth. Unemployment rates are still relatively low; St. Louis just published an unemployment rate of 5 percent, its lowest in a number of years. And there has been a pickup recently in nonresidential and residential construction contracts. Even at GE, for example, the feeling is that this process isn't cumulative; they see a bottoming out here. I think they feel that with these announced layoffs their production will be in line with demand. They see next year as being relatively flat but they don't see a continuing deterioration. One final thought--which I mentioned last time and it continues to be the case--is that I've been traveling around the District a little and it's very hard to find businessmen who are worried about the economic situation. Nobody grabs you by the lapels and says: "This thing is going south and you better do something about it."

CHAIRMAN GREENSPAN. Governor Johnson.

MR. JOHNSON. On the real economy, growth seems to be continuing at a fairly modest rate as compared to what looked like a slippage earlier. So, as far as the economy's performance, there is some inertia there that is satisfying, I think. I don't see it much different than the Greenbook has in terms of the pattern that may be developing. Did you say, Mike, that manufacturing inventories were coming out this morning?

MR. PRELL. Right, and they were up \$12 billion at an annual rate.

MR. JOHNSON. As opposed to a stronger--

MR. PRELL. It was \$50 billion in July.

MR. JOHNSON. And that is a good sign.

CHAIRMAN GREENSPAN. And the inventory/sales ratio went from 1.64 to 1.56.

MR. PRELL. You're ahead of me on that; I don't have those numbers.

MR. JOHNSON. Well, that's a good sign in that the bulge in inventories in July did not carry forward.

CHAIRMAN GREENSPAN. A good part of that is a big increase in auto shipments and sales.

MR. JOHNSON. Right, but there was some uptick even ex autos, if I remember, before July.

MR. PRELL. Right, there was a pretty broad--

CHAIRMAN GREENSPAN. I was referring to the sales.

MR. JOHNSON. Yes. In spite of all that, I still see it like the Greenbook forecast--some winding down in the economy. I don't see any signs of acceleration, taking all the regions on balance; I still see some gradual slowing going on. So, I perceive a little more downside risk than upside risk. But I want to associate myself with Gary Stern and others who earlier indicated a little optimism on the inflation front--that inflation seems to be looking better and it seems to go beyond just the food and energy components. But as even Mike Prell said, a lot of the ex food and energy improvement seems to be associated with the dollar, to some extent. I'd be quite alarmed if we continue to contaminate the environment we have for improvement with a drop in the dollar. I'm not saying we ought to be targeting the dollar, but given the fact that we are at high capacity levels, we don't have a lot of fudge room there unless the economy were to slow further and we could absorb some decline in the dollar. So, that is a big, big worry. And even though I think the risks are still toward the down side, the current environment is not very promising for any flexibility on policy.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. It seems to me that the picture is a mixed picture. I'm somewhat on the optimistic side, as are Gary Stern and Manley Johnson, in regard to the output-price tradeoff. It seems to me that in the second half we are in a 2-3/4 percent inflation mode as compared to 6 percent in the first half. I would agree that neither one of those was sustainable. That is, I think we had accidental factors giving us too high inflation numbers in the first half and we are getting some benefits in the second half that are not sustainable. But I would tend to expect inflation in 1990 to be within the 3 percent range. I don't call that good at all. My goodness, we are two years delayed in terms of being at 3 percent and I think we do need to make more progress. But I think our ability to make progress on the inflation front can best be done by not creating recession-like conditions. And I'm optimistic that that will not occur. M2's growth over 26 weeks is now back up to 4-1/2 percent, which seems to me to mean that we have made some progress in that regard. Commodity prices continue to soften, but I think it's a rather moderate softening and not a precipitous one. It seems to be a softening that reflects the

monetary scarcity that occurred earlier; and I think that needs to be watched rather carefully as I think money growth needs to be watched. But I do believe there's a different tone around in regard to how one can profit by engaging in various economic activities. I think profit prospects or speculative gains by holding land or real estate or any investments are probably being diminished somewhat. And it doesn't seem to me that this is going to lead to a sustainable level of investment activity in many of these areas. I am as bullish as the staff is in regard to exports. In fact, I have exports slightly higher with a stable exchange rate, whereas the staff is calling for exports to decrease dramatically--well, I'd call down to 5 percent somewhat of a dramatic decrease. I believe that we have had the benefit of having American manufacturers compete in the world markets right here in the United States; I think they are getting better and I think there is motivation to hold costs in check. So, I think it's an optimistic outlook; but there are some areas, like the airline business, that are showing some signs of change. So it looks sustainable.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I have adopted a self-imposed task of delivering jeremiads from time-to-time about things that are going on that are somewhat outside the economy and present a backdrop against which we need to apply policy. I'm not going to repeat that this morning, but I would just like to get on the table the fact that there are a host of very important challenges and problems in the economy that are very urgent and on which, in many cases, we seem to have an opportunity to make some substantial progress. They are not economic in many cases; but in virtually every case they are substantially impacted by economic events and economic conditions. As I look at the economy, I'm close to where I think Governor Johnson and President Black and others are in that it's hard for me to see where meaningful strength can come from and relatively easy to see where weakness can come from. And that gives me some pause. I would suggest that we ought to be rather sensitive to emerging weakness and be quite careful that we don't induce something through policy that would turn out to be counterproductive to society in a larger sense.

CHAIRMAN GREENSPAN. Jeremiah Corrigan!

VICE CHAIRMAN CORRIGAN. Well, in terms of the near-term outlook I'd be in the moderate but steady camp that somebody--I guess Dick Syron--mentioned. As I said to you this morning, there is some evidence of a lessening in prices for some raw materials and intermediate goods and even some evidence of modest improvement in availability of deliveries. But all-in-all as I look at the current situation, my bottom line is that I fear it will be weaker and my instinct is that it will be stronger. Therefore, I think it's about balanced. But let me take up a further [unintelligible] in terms of the intermediate-term outlook. The staff has taken the forecast in the Greenbook through the end of 1991 and I think what the staff is saying is very, very revealing. You may not like it, but I think it is probably the most exhaustive and professional insight that you can get. What does it say? It says: 2 percent growth for three years running; the unemployment rate rising to 6 percent; the saving rate falling again to 5 percent; the CPI with or without food or energy stuck in the 4 to 4-1/2 percent range; compensation per man hour stuck

at 5 percent; the fiscal deficit still over \$100 billion; and the trade and current account deficits at the end of 1991, even with some depreciation, still around \$100 billion. Net external liabilities at the end of '91 are going to be \$1 trillion and portfolio net income flows are going to be minus \$50-odd billion. It seems to me that what you get out of that is an intermediate-term outlook that I consider to be in some ways as good as you can expect but in other ways very, very risky and dangerous. It tells me, as we all know, that we have an absolutely lousy policy mix in this country. It tells me that there are great risks of a renewal of protectionist attitudes in this country. It tells me that there are risks even in terms of the ability of this country to provide leadership. And it certainly tells me that there are very grave risks in the economic outlook in terms of growth, inflation, and the exchange rate. I think the exchange rate risk over time is clearly on the down side. That's one of the reasons why, though I may not agree with the analysis, I certainly agree with the stated concerns about the dangers of beating up on the dollar. But I don't consider this three-year outlook anything but trouble looking for a place to happen somehow or other.

CHAIRMAN GREENSPAN. Governor Seger.

MS. SEGER. I can't worry about where we're going in two years because I don't think most of us can forecast even two quarters ahead let alone two years ahead. Looking a couple of quarters ahead, though, I do think that the slowing that we have seen is going to continue. What concerns me greatly is the weakness that I see in various manufacturing areas. And the weakness in manufacturing, I think, is more serious than the overall weakness. The Purchasing Managers' Survey for the last five months or so has indicated this slowing; I have other sources of information as well. Just to repeat a couple of things that Si Keehn said about the auto industry: using the current production schedules for the fourth quarter this will be the weakest fourth quarter since 1982 and you may remember that 1982 was not exactly a hot year for autos. Even if you pick up the transplants which, of course, have become very big and very important over this last seven years, it still will be the slowest fourth-quarter production since 1982. Frankly, one of the reasons two or three of the auto manufacturers have announced incentives for their 1990 models even before they are readily available is that they are so nervous about the weak demand. In some cases, they do not have enough orders even to start their plants running to produce the 1990 models. So, I think the people who looked at the August auto sales numbers and read them as a sign of strength got the wrong message. It was end-of-year close-outs that they really pushed. It's just about 180 [degrees] away from a strong story; it's a weak story.

Also, if interest rates actually perform as the Greenbook assumes--if short-term rates are basically flat during the year ahead and long rates rise slightly--I'd be very hard pressed to expect housing to improve. Maybe I'm missing something and maybe consumers are interested in buying more, but the builders--at least in the builders' survey that I read--are feeling rather negative. That's particularly true in parts of the country that have been alluded to here earlier. The export situation really has to be watched. I think the strong dollar that we have seen over much of the year, until the [unintelligible] began recently, has had an impact on export growth; I believe it's going to have an additional impact because there are long

lags involved here. Also, there has been a rather significant deterioration in profits going on. The IBM announcement a couple days ago of disappointing earnings in the third quarter and expectations of disappointing earnings for the full year, I think, is a great concern. They have announced that they will offer early retirement to some more people, which is not exactly very IBM-like. If you read the press release carefully, it mentions that the strong dollar was one of the things contributing to their deteriorating profits because of the translation problem--the profits that they are earning abroad and then bringing back into their consolidated earnings report for this country. It's my personal observation that when a company experiences profit deterioration, that eventually impacts on its willingness and ability to expand and even to modernize dramatically. So, I'm probably a touch more concerned than the average around the table. And if the stance of monetary policy is what we're assuming in the Greenbook, then I think I would be a lot more nervous than the average here. Thank you.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. Well, I'm kind of sorry I didn't get in ahead of President Corrigan because he summed up so perfectly my own views of what some of the risk factors are in the near future--accidents looking for a place to happen. I'm very concerned about the fact that the outlook is for sluggishness with no real progress on any of our major problems. It seems to me that the greatest fragility in what we see going on right now is the possible effects of the dollar's behavior. While I understand that solving the current account crisis and the trade crisis is a necessary part of our planning, or hopeful planning, it seems to me that it is not going to get solved all by itself just by driving the value of the dollar down. The dollar is behaving right now like a strong swimmer. But sooner or later, even the strongest swimmer is going to go the bottom if you push his head under water again every time he comes to the surface. And I worry that any kind of a free fall in the dollar in the near future could drive people away from dollar-denominated securities and reverse this interest rate structure very dramatically by forcing the financing of our deficits back into our own markets. And that would rob us of the monetary policy flexibility that we need in order to keep some sort of an even keel through this perilous period. So I'm worried, and that's the issue that I have come to focus on--worried and frustrated, I guess, sums it up.

MR. JOHNSON. I wish I had said all that. That's good.

CHAIRMAN GREENSPAN. I suspect this may be an appropriate time to break for coffee.

[Coffee break]

CHAIRMAN GREENSPAN. Mr. Kohn.

MR. KOHN. [Statement--see Appendix.]

CHAIRMAN GREENSPAN. Questions for Mr. Kohn?

MR. HOSKINS. Don, on your longer-term projections, I don't know what you're projecting for 1991. The Greenbook tells us we will

have 4 percent inflation or so in '89, '90 and '91. So, given the forecast for inflation, it seems to me that we're implying somewhat higher than a P* kind of M2 growth. In other words, don't I have to see some 2-1/2 or some 3 percents, on average, over time to--

MR. KOHN. Well, eventually you would have to see that. You would have to see 3s [in M2 growth] to imply price stability; this is in line with Governor Johnson's question earlier. If you look at the financial indicators that were distributed--the last chart, chart 9 has the P*--we are assuming 6 percent M2 growth in 1990, about in line with nominal GNP, and a small decline in velocity. In 1991 we have 5 percent, a bit lower than nominal GNP, and a small rise in velocity since we have this upward drift in interest rates in that year. Those two taken together imply in the P* model--to keep P* just a little below P--a very mild deceleration in inflation, not a rapid one. The line is tilted down but not at a very steep angle.

MR. GUFFEY. We're having trouble seeing that.

CHAIRMAN GREENSPAN. What would happen if P actually reached P* at the end of '91? What is the gap at the moment in that?

MR. KOHN. I can tell you that in a second. Well, at the end, if P were lower than--

CHAIRMAN GREENSPAN. No, equal to the P*.

MR. KOHN. Well, given the money growth that we've assumed, that would require then that prices come in less than the rate--

CHAIRMAN GREENSPAN. That's what I'm saying.

MR. KOHN. --and presumably we would have that P equal to P*. That would imply very little further downward pressure on--

CHAIRMAN GREENSPAN. No, no. If at the end of 1991 P* is under P, then that gap is the measure of how much prices would fall if P were equal to P*. I'm asking--

MR. KOHN. Right.

MR. BLACK. How big is the gap is what he's asking.

MR. KOHN. Okay.

CHAIRMAN GREENSPAN. On the chart it looks as if it could be as much as 2 percent.

MR. KOHN. At the end of 1991 P* is 1.345 and P is 1.381, so [the calculation] is .04 over 1.38. It's about 3 percent, I'd say, or whatever .04 over 1.38 is.

CHAIRMAN GREENSPAN. .04?

MR. KOHN. Well, .04 over 1.38. So it's 2-1/2 percent or so.

MR. TRUMAN. 2-3/4.

MR. KOHN. 2-3/4.

CHAIRMAN GREENSPAN. [Unintelligible] a P* operation is that we could get a lower [inflation rate]. I'm not saying it's forecast; but it's not an argument that you could get a lower inflation rate consistent with that money supply growth [unintelligible].

MR. KOHN. I'm not sure I understood what you just said.

CHAIRMAN GREENSPAN. I'll say it again very explicitly.

MR. KOHN. I'm sorry.

CHAIRMAN GREENSPAN. The hypothesis that employs the M2 growth, which is better, is therefore not inconsistent with a lower inflation rate than is in the Greenbook for '91.

MR. KOHN. Right. Actually, relative to the Greenbook, in '91 the P* would give you 3-1/2 percent on the implicit deflator. The Greenbook has 3-3/4 percent, so it's not much different. I thought what you were getting at is what it would imply for '92. Presumably, that is where you're coming out of '91 and that would imply some further deceleration.

CHAIRMAN GREENSPAN. Well, '92 is an easy forecast; it's '91 that--

MR. HOSKINS. Can I follow up? The shorter-term problem, from my perspective and not obviously from other people's around the table, is that we're going to have a growth rate--going into the fourth quarter and starting the first of the year--of around 6-1/2 percent. Isn't that kind of a speed problem in the sense that we are accelerating?

MR. KOHN. Well, if interest rates were to hold steady, I would not expect money growth to accelerate in the first quarter particularly.

MR. HOSKINS. Okay.

MR. KOHN. Presumably, if interest rates didn't come down we wouldn't get the acceleration; I would expect M2 growth perhaps to decelerate slightly. But it would be basically in the 6-1/2 to 6 percent area in the first quarter.

MR. HOSKINS. It's just a problem for me to look at M2 growth of 5.2 percent fourth quarter-over-fourth quarter the previous year and your projection of about 4.5 percent [for 1989] and now to see you project that M2 growth is going to go back up to 6 or 6-1/2 percent. The argument generally has been that the cost of bringing it down because of interest sensitivity is too high--you get big swings in M2. But you can turn that around and say you can bring M2 down with relatively small swings in interest rates.

MR. KOHN. In the short run that's right. This is the phenomenon that we discussed in July, I believe, when we were talking about the long-run ranges. The staff forecast with relatively flat interest rates was consistent with M2 growing about in line with

nominal GNP. So if you think you're going to have nominal GNP growth on the order of 5-1/2 or 6 percent next year you're going to get M2, given that we've had a little decline in these rates, on the order of 6 or 6-1/2 percent, just mechanically working it through. But you could raise interest rates a bit and you would get a little lower nominal GNP. You would also get even more impact on M2 given that interest rise.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. A theoretical question, looking out and going into next year: If the capital gains legislation were to pass--and there is a lot of discussion about windows and that sort of thing--what kind of effect will that have on M2 as we go into next year?

MR. KOHN. We discussed that to some extent. If there is, it could be a bit of a replay of 1986. If people realize a lot of capital gains quickly and then store the money waiting to pay their taxes next April, for example, we could have some temporary upward movement of M2 or a [unintelligible] level of demand for M2 in the short run, which would then come back presumably after the taxes were paid. It would be a little different than we saw in 1989 when we thought people were surprised in April by their tax returns and they drew down their M2 balances and then had to move them up. You could argue in this case that, perhaps having learned from 1989, people might deliberately make a decision on the basis of taxes in that they might be more tempted to take some of the capital gains they got and leave them in M2 and have that ready--

CHAIRMAN GREENSPAN. Wouldn't that degree of sophistication imply more M3 than M2?

MR. KOHN. Depending on who's doing it, yes. If it were--

CHAIRMAN GREENSPAN. If somebody were sophisticated enough to act in context of that law, one would assume it's more an M3 possibility.

MR. KOHN. Possibly. I think there are probably a number of households with very high wealth and, therefore, potentially high M2 holdings who--if they were to park it there temporarily--could do this. Presumably, if there were a mood shift out [of M2] into M3-type liabilities, such as large time deposits, etc., from the bank and thrift perspective they would have to issue fewer other types of M3 liabilities. So, I'm not sure whether that would really affect the level of M3 so much. I think there might be some impact on M3.

CHAIRMAN GREENSPAN. Anybody else? Why don't I get started on policy issues. This ought to reflect much of what I've been listening to here because I, too, think the outlook is mixed, with some key timing points in the period immediately ahead. It's fairly clear that the evidence for weakness, if one looks at that part of the spectrum, is most persuasively coming from the orders pattern, specifically in durable goods. The nondefense capital goods area, excluding aircraft, clearly is scaling back at a fairly pronounced pace, including declines in backlogs in nominal terms. What's unclear at this stage is to what extent that order easing is a reflection of real underlying weakness in capital equipment or merely an order

adjustment process to a significant decline in average lead times on the deliveries of materials and parts. Obviously, if you're bringing the lead time down from, say, 90 days to 60 days--that's not the actual number--one can collapse the unfilled order pattern and orders would fall without affecting total plans for shipments. If that is a major cause of this phenomenon, owing to the fact that the order lead times are now probably at rock bottom, at least in the context of this country, it would follow, therefore, that within the next several weeks we should begin to see some firming in orders. The purchasing managers' order data have stopped their accelerating rate of decline; in other words, they are still implying a decline but the decline has stopped accelerating. And there is some evidence popping up in a variety of different places that suggests that maybe the softening is coming to an end. I don't think we're going to know that for another three or four weeks.

The one aspect of the issue which I must say concerns me is the notion that this may be something more than that. The argument for it being more than that is the continuous, cumulative decline in profit margins that has occurred since the spring. It's clear that what has occurred is that the slowdown in volume, coupled with the price slowdown, has had a significant impact on the revenue side; the slow volume clearly has raised fixed costs and especially the extraordinarily high interest payments of the corporate sector. In fact, the series that we produce internally--the ratio of gross interest payments by corporations as a percent of gross cash flow--has spiked up in the last two quarters partly, I suspect, as a result of the interest increases that are going on but also because of a slowdown in cash flow, which is another way of saying that there is pressure on margins coming from this gradual slowing up. It is not reflected in the Greenbook too much, so maybe these numbers are not an issue of concern as much yet. But I do think that the capital goods markets are the key to this outlook. If capital goods hold up, I think there's very little chance that this economy can move down; in fact, if capital goods markets hold up we might exceed the Greenbook easily. But if the capital goods markets continue to erode and then accelerate down, then we get a significant backing up of in-process inventories in the system. We look at inventory data of purchased materials, goods in process, and finished goods from the establishment level. But there's a very significant part of all of those inventories which are really in process. If you consolidated them under their final sales level, for example, you'd find in the capital goods area that the proportion of inventories that were [in process] would be very high and that would tilt over the capital goods situation; even though the inventory sales ratios don't look formidable, you do get enough pressure to create some recessionary forces. This is the downside argument. The upside argument is basically that if this process were underway, it's already overdue on the basis of historical experience. This economy doesn't work that slowly. In other words, when you get these types of patterns, they trigger things and they go at a much faster pace than anything that we have seen. That sort of suggests that this might be a false move.

In any event, when I look at this and translate it into policy, it says to me at this particular stage that the argument for moving in either direction is rather dubious at this point. One major reason is that if we were to move down--well, let me put it this way: Moving up at this point strikes me as very unsupported. I don't know

a reason for doing that and nobody around here even remotely suggested it. But moving down right at this moment [is problematical], in light of what is presumed to be an increase in the Bundesbank rates on Thursday and a coordinated attempt on the part of the G-7 to now put monetary policy on the table and bring the dollar down--and believe me it will succeed; it will go right through the floor. If we were to get anywhere close to moving rates down in conjunction with the Bundesbank move, I'm fearful that we would get too much market response as the new G-7 coordinated monetary policy endeavors to bring the dollar down. And I think that would create some really major problems for us. I conclude, therefore, that at least where I'd like to come out would be alternative B, asymmetrical toward ease as we are now. And I would keep a close eye on the order patterns because we do get information coming in continuously. If the patterns weaken considerably, I think that probably would be suggesting to us that the capital goods markets are beginning to slip off. I don't think that's where the odds lie, but it is still a disturbing possibility. If the more probable event occurs--namely, that the economy is about to stabilize--I think we will know that in several weeks. In any event, I would like to suggest as a policy position alternative B, asymmetric toward ease. Governor Johnson.

MR. JOHNSON. Yes, I'd like to associate myself with that view. I'm not sure I'd explain it the same way. My major concern right now--even though I think there is a downside risk and we ought to be prepared to use our flexibility to ease at some point--is that the atmosphere is not right. I think there are still some questions going forward and we ought to wait and look. My major reservation at this point is what is going on with the dollar and the fact that any attempt to ease now, even if we thought it was the right thing to do, would have great risks because the perception [would be] that our goals were associated more with some dollar level than our view about inflationary risks. And I really don't want our policy tied in with that. So, I prefer to maintain our flexibility going forward.

CHAIRMAN GREENSPAN. President Parry.

MR. PARRY. I would certainly support alternative B, but I would have a preference for symmetrical language because I think the data to date suggest that the risks are equal on the up side as well as on the down side.

CHAIRMAN GREENSPAN. President Forrestal.

MR. FORRESTAL. Mr. Chairman, I would certainly support your prescription for policy in the short term. I think it's exactly on target with respect to the dollar. Any easing at this point would be associated with dollar movement and that has very grave risks, as you stated. I think we're at a point where we ought to be fairly happy with the state of the economy. Clearly, there are risks and they have been articulated very well; I don't minimize them. But I certainly find it very hard to imagine a stronger case for leaving policy unchanged at the moment. I, too, would prefer a symmetrical directive only because I think that the risks are about evenly balanced.

CHAIRMAN GREENSPAN. Governor LaWare.

MR. LAWARE. I'm strongly in favor of alternative B. I think the risks of easing because of the dollar situation are significant. Therefore, I would prefer the symmetrical language.

CHAIRMAN GREENSPAN. President Hoskins.

MR. HOSKINS. My concerns, again, remain in the longer term, not this short-term consideration. My fear in the longer term is not that inflation is going to get out of hand on the down side. It seems to me that if it's going to get out of hand it's going to be on the up side. That seems to me to be where the risk is: trying to head off a recession that is not there will always bias us toward inflation and volatility in the inflation rate. I would prefer the "B" path. I'm not so comfortable that I'd want to tighten right now but I would have asymmetry in the other direction on the notion of getting the M2 path below 6 percent for next year.

CHAIRMAN GREENSPAN. President Syron.

MR. SYRON. Like many others, I'm happy with the current state of the economy. But also like many others, I'm not happy about the outlook, particularly on inflation, as we go out a couple of years. I know the errors that such a forecast has. I understand the constraints that are on us as far as the dollar goes. Because of my longer-term concerns on inflation I'm very comfortable with "B," but I would also prefer symmetrical language in the hope that the market would see symmetrical language as no change.

CHAIRMAN GREENSPAN. President Boehne.

MR. BOEHNE. Alternative B, and I think asymmetrical is fine. I could also live with symmetrical. I should say that while this makes good economic sense, I think it is going to be somewhat confusing to observers of this whole process in that we have been intervening to drive down the dollar and, if the Germans raise interest rates, there will be an expectation that this is a coordinated effort. And if we don't follow through--I agree we should not follow through, that's not my argument--I think it will raise a number of questions and will sire a number of speculations about where the Fed is in all of this. That's more politics and public relations, but it is nonetheless part of the world.

CHAIRMAN GREENSPAN. President Keehn.

MR. KEEHN. I'd be in favor of alternative B and asymmetric language. It seems to me that what we're basically saying is no change in policy. A word change is awfully minimal; nonetheless, I'd prefer remaining with asymmetric language at this point.

CHAIRMAN GREENSPAN. President Stern.

MR. STERN. Well, I too favor alternative B. I have a mild preference for symmetric language just against the circumstances in which we find ourselves. There are indeed a lot of problems that might impinge upon us, but it seems to me that the best policy we can adopt, given all these potential problems, is to try to keep the economy on a relatively even keel. And I think "B" accomplishes that. I certainly wouldn't want to see M2 growth in the near term--by that I

mean the fourth quarter and going into next year--go above that associated with "B." I do think our credibility is very important and I think we have to be very careful about that matter.

CHAIRMAN GREENSPAN. Governor Angell.

MR. ANGELL. Yes, Mr. Chairman. I also prefer alternative "B" with asymmetric language toward ease. It seems to me that there is more restraint in place than I think some of the words so far have suggested. We have had monetary restraint sufficient to turn the foreign exchange value of the dollar around. We have had monetary restraint sufficient to take commodity prices that were rapidly rising and turn them into falling prices. We have had monetary restraint that has taken the PPI on a year-over-year rate of change basis from moving up to moving down. To think you can get lucky enough in that kind of environment to do that and have no change in monetary restraint and to think that that restraint is going to be just right on the other side does not follow the logic that I know of. So, I'm quite suspicious of the fact that we may be getting further into this process than we know. We need to be watching very carefully to see what occurs. Now, I would be delighted if we could just say: Well, we're going to pull the monetary aggregates down and we're just going to have them under restraint; but I think all of us know what happens if you go into that mode. The demand for money has to increase during a period of time in which price level stability is much more of a clear possibility. So, I think we have to watch very carefully all the signals that have served us so well in keeping this economy going for so long and yet provided the restraint that we needed. I believe that it's not so important at this point whether we ease a quarter or not here or there except that I don't want any timing with the dollar. But 25 basis points one way or the other doesn't make or break anything. You could make way too much of that. But it does contribute to the possibility of orderly markets that are so important; the whole housing industry, it seems to me, needs orderly markets. I think a very steady, careful, easing ought to be done; it's unfortunate that the G-7 took away what I think may be a time in which we may need to act. I think it's essential that we take this time to wait, but I am more inclined, I guess, than some others to believe that an easing is going to be necessary.

CHAIRMAN GREENSPAN. Governor Kelley.

MR. KELLEY. Mr. Chairman, I support alternative B with asymmetric language toward ease. That's where we are now and I see no reason to change it. I concur with Governor LaWare that the risks on the dollar are certainly there; you articulated them beautifully. But I also believe that that's going to have to be played out on a day-by-day basis. It's a little hard to know how that's going to go. I think that you and the Committee can and will adequately take that into account as events unfold. Meanwhile, I think the potential for weakness in the economy and the consequences of it--if we get it and it gets away from us--are severe. I may be a cockeyed optimist but I think there's a possibility that we will continue to get better inflation results than expected. As a consequence, it seems to me that your proposal is appropriate.

CHAIRMAN GREENSPAN. President Melzer.

MR. MELZER. I favor "B." Symmetrical language would be my preference but I could live with asymmetrical toward ease. I would just comment that several months back I was concerned about the degree of the restraint. I'm not sure what to make of M2. But in terms of some of the narrow aggregate and reserve measures, I take some heart in the fact that they had a pickup in September and are projected to pick up [further] through the end of the year. So, I think that the shift that Governor Angell was concerned about to some extent has taken place, at least based on those [data].

CHAIRMAN GREENSPAN. Governor Seger.

MR. SEGER. I favor alternative "A" because I think we do need a slight degree of easing; actually, I believe the difference between "A" and "B" is basically a slight one.

CHAIRMAN GREENSPAN. That means easing immediately?

MR. SEGER. Yes. I don't think the 25 basis points is going to pour rocket fuel into our engine. Anyway, my main concern, as I indicated, is in the auto area and possibly in the capital goods area. In regard to the impact on the foreign exchange markets, I think the demand situation there is one of great strength for the dollar, which is why we had to be in there doing this heavy intervening and selling of dollars along with the other central banks. If we drop the interest rates slightly, then that would allow Sam Cross' people to take two days off and maybe that would be good. So, I don't think that that would be a real danger. Finally, just thinking back to our discussions here earlier this year about inflation, the actual performance of price indexes has been far better than any of us dreamed. And I don't think the apparent shortages that were so worrisome are there now. While I don't think inflation has gone away --and I say that so Lee Hoskins will understand--nevertheless, I don't think it is accelerating either. So, I would be more comfortable with alternative A.

MR. LAWARE. Martha, the Bluebook says that "A" is related to a 50 basis point drop. Would that change your view on that?

MS. SEGER. I'm sorry, I meant 50.

MR. LAWARE. Okay.

MS. SEGER. No, it wouldn't.

CHAIRMAN GREENSPAN. Vice Chairman.

VICE CHAIRMAN CORRIGAN. I'm comfortable with alternative B. I guess I prefer symmetric but since we have asymmetric, that's fine--just leave it there. I would come out there pretty much on the grounds of my own assessment of the domestic economy, although the exchange rate situation makes it a bit more compelling. I would note, Mr. Chairman, tongue somewhat in cheek, that I'm not prepared to make this argument, but much of the earlier discussion today would not be incompatible with tightening monetary policy.

MR. ANGELL. Do you mean drive the dollar higher?

VICE CHAIRMAN CORRIGAN. A whole variety of things: the dollar, price stability, making room for export growth. You could make a pretty good argument based on the discussion around this table that we should be tightening policy. I'm not prepared to make it.

MR. KELLEY. You'd get a pretty darn good argument if you did!

CHAIRMAN GREENSPAN. President Black.

MR. BLACK. Mr. Chairman, I'm very sympathetic to the point that Lee Hoskins made because I tend to focus on the longer run, as I think he does. And I think our long-run problem is inflation rather than recession. I'm also sympathetic to the points made by those who favor symmetry just because I'd like to send a signal to the market that we don't really approve of the G-7 action. But I also share Wayne's feeling that monetary policy has been a little tighter than most people assume and that it may be [sufficient to] hold down the inflation risk. So, I think your original formulation is probably the best one for now; I would go with "B" asymmetrical on the easing side.

MR. GUFFEY. [Unintelligible] and I think most of the comments around the table about using monetary policy with respect to the dollar are right on the mark. I don't think the old adage "you can't serve two masters" is to be taken lightly. I think monetary policy should be devoted to domestic economic policy and not to the dollar. And further, with respect to the prescription for the period ahead, I would accept "B" but would want a symmetric directive. I wanted that last time, as you may remember, and I've seen no accumulating evidence that suggests we are any closer to a recession at this meeting than we were at the last meeting. As a matter of fact, in my own view, we're further away from it. As a result, I think there's a greater demand for a symmetric directive than there was last time. Therefore, I would prefer "B" symmetric.

CHAIRMAN GREENSPAN. President Boykin.

MR. BOYKIN. I favor alternative B. My preference also would be for symmetric language.

CHAIRMAN GREENSPAN. The consensus is obviously alternative "B" with some concentration for asymmetric toward ease, which I would like to take a vote on. But I will say that since there's enough in the way of desire for symmetric language, should the evidence emerge that action is required I do think it might be useful to have a telephone conference and discuss what the issues are; they are likely to be subtle and the Committee's views would be useful. In any event, I would like to propose a vote on alternative B with asymmetric language toward ease. Would you read the directive so stated?

MR. BERNARD. "In the implementation of policy for the immediate future the Committee seeks to maintain the existing degree of pressure on reserve positions. Taking account of progress toward price stability, the strength of the business expansion, the behavior of the monetary aggregates, and developments in foreign exchange and domestic financial markets, slightly greater reserve restraint might or slightly lesser reserve restraint would be acceptable in the intermeeting period. The contemplated reserve conditions are expected

to be consistent with growth of M2 and M3 over the period from September through December at annual rates of about 6-1/2 and 4-1/2 percent, respectively. The Chairman may call for Committee consultation if it appears to the Manager for Domestic Operations that reserve conditions during the period before the next meeting are likely to be associated with a federal funds rate persistently outside a range of 7 to 11 percent."

CHAIRMAN GREENSPAN. Call the roll.

MR. BERNARD.

Chairman Greenspan	Yes
Vice Chairman Corrigan	Yes
Governor Angell	Yes
President Guffey	No
Governor Johnson	Yes
President Keehn	Yes
Governor Kelley	Yes
Governor LaWare	Yes
President Melzer	Yes
Governor Seger	No
President Syron	Yes

VICE CHAIRMAN CORRIGAN. Mr. Chairman, could I raise another question before we formally adjourn?

CHAIRMAN GREENSPAN. Sure.

VICE CHAIRMAN CORRIGAN. I wonder what the sentiment around the table might be, looking forward to our next meeting, to ask Mr. Prell and Mr. Truman and Mr. Kohn and others to do a special presentation for the Committee where we would take a look at this question of price stability in five years in some systematic way. I'm not suggesting a forecast but alternative scenarios, problems, obstacles, and costs, so that we could really get a systematic feel of what kinds of problems would be involved in that kind of underlying policy goal. I don't think--

CHAIRMAN GREENSPAN. [Unintelligible] suggestion.

MR. PARRY. One [other point]: I'm sure you all got this letter to respond to by the end of October or early November from Representative Neal and that kind of information might be useful. I don't know what we're all going to do about that but that kind of information might be an important--

CHAIRMAN GREENSPAN. What is the deadline for answering that letter?

MR. PARRY. The end of October or early November is my recollection.

MR. HOSKINS. He just said as soon as possible.

MR. PARRY. Well, he says he'd like to make it a part of the record and he will be doing the hearings in late October or early November. And we assumed that--

MR. LAWARE. We are not all going to answer that separately, are we?

MR. ANGELL. Do we want the FOMC [to respond]?

MR. FORRESTAL. That's the question I was going to raise--no way.

MR. JOHNSON. I think we ought to [respond] as the FOMC.

MR. ANGELL. I would think we should have one response.

CHAIRMAN GREENSPAN. Do we all agree?

MR. FORRESTAL. That's what we have done in the past.

MR. HOSKINS. Well, I'd like to discuss that.

VICE CHAIRMAN CORRIGAN. Well, putting aside this other view, I don't want to prejudge the letter.

CHAIRMAN GREENSPAN. We will discuss the letter at our luncheon.

VICE CHAIRMAN CORRIGAN. We have to deal with that. But quite apart from that, I really think that we ought to put this exercise under a microscope so we really have a--

SPEAKER(?). Well, this is something [unintelligible].

VICE CHAIRMAN CORRIGAN. Well, I'm just trying to formalize that.

SPEAKER(?). Yes, I agree.

MR. HOSKINS. What model are we going to use?

MR. ANGELL. The model that works.

VICE CHAIRMAN CORRIGAN. That's why I want to look at it.

MR. KOHN. I think this will be something of a time consuming exercise at the FOMC meeting as well as for the staff between here and there. Aside from this Neal question which, if it needs to be answered by early November would precede the FOMC meeting anyhow, we do have a two-day meeting scheduled for December. The November meeting was to be a Tuesday afternoon meeting in any case. So before President Parry brought that up I was going to suggest that maybe we schedule it for the December meeting, but I'm not sure how it interacts with this Neal letter. We could have a Tuesday afternoon/Wednesday meeting.

MR. ANGELL. Well, how about a Wednesday morning meeting with [Wednesday] afternoon?

MR. KOHN. Some Presidents don't like that when they have Thursday directors' meetings.

CHAIRMAN GREENSPAN. The answer to that letter has to come long before any of this other stuff occurs. And I'm not altogether certain that the answers to the letter per se are going to be really tied up in any analytical issues. I think what's involved here is looking at the problems in financing the large budget deficit, not pressures on the money supply. What we really have to deal with, crucially, is what real rate of interest is consistent with a path of money supply which itself is consistent with zero or moderate inflation. Because it's the real rate of interest that will tell us, literally, the capabilities of bringing the system into balance. And I'm not sure that that really gets to this letter or anything related to it.

MR. JOHNSON. Plus, it seems to me that there has always been a [unintelligible] definitions which has to be addressed as well. You could probably go around this table and find half a dozen different views about what price stability is. I know I have one.

CHAIRMAN GREENSPAN. Yes, but I bet you they don't differ by more than 10 percentage points.

MR. BLACK. That's exactly the problem.

MR. BOEHNE. Well, if we have to reply to this letter over the next month, and if we're going to have a two-day meeting in December anyway, this idea of price stability isn't going to go stale between now and Christmas.

CHAIRMAN GREENSPAN. I wouldn't think so.

MR. BOEHNE. So, I think we ought to let it flow into our natural schedule.

CHAIRMAN GREENSPAN. Okay. There is a fundamental problem that we have with this whole procedure in the sense that there are a lot of [unintelligible] things that have to be done in economic policy. And with fiscal policy now out of the game, and really monetary policy and sterilized intervention being the only [unintelligible] there's an awful lot of mischief that can occur. But I think it's those types of questions that we need to ask.

MR. BOEHNE. I agree.

MR. ANGELL. Well, the model that we're going to use is going to be rather important. It seems to me that if you're going to use the Phillips curve trade-off model you're going to defeat the Neal amendment.

VICE CHAIRMAN CORRIGAN. What you want to do--

MR. ANGELL. [Unintelligible] if you want to defeat it, just use that model and you will guarantee a defeat.

MR. BOEHNE. On the other hand, if you think you're going to get this like a free lunch, that's not realistic either.

MR. SYRON. And it depends on the time periods you're looking at. I think the Neal letter is consistent with looking at this over a long period of time. Most people don't behave--

VICE CHAIRMAN CORRIGAN. [Even] over five years there are going to be costs.

MR. SYRON. There are going to be costs but there is going to be a benefit in that over the long period of time after that prosperity will be greater.

CHAIRMAN GREENSPAN. Well, at a minimum, just having a focused Congressional examination of this process cannot be bad.

MR. BOEHNE. I'd rather Congress be debating this about monetary policy than a whole lot of others things they could be debating.

CHAIRMAN GREENSPAN. Exactly. I think it forces them to focus on the--

MR. BOEHNE. Right, I agree with that.

CHAIRMAN GREENSPAN. --costs and benefits. Whatever comes out is unlikely to be anybody's--

MR. BOEHNE. But I think it's also a good opportunity, even though fiscal policy is in a state of paralysis, to remind people about what good things could happen if it weren't.

MR. JOHNSON. How about Bill [unintelligible] might testify? He had--

VICE CHAIRMAN CORRIGAN. Well, I think he would say that.

MR. LAWARE. They might come to that conclusion anyway if they examine the costs of getting there. They may say "Oh, no way are we going to pay that price." That's the danger on the other side.

CHAIRMAN GREENSPAN. I will tell you: If you went back to the 1960s I would say you probably would have had 2 to 1 against it as far as economists are concerned. I bet you now it's 1 to 2 the other way.

MR. BOEHNE. It probably is.

MR. ANGELL. That's right.

MR. BOEHNE. That's probably right.

CHAIRMAN GREENSPAN. The old Phillips curve trade-off was one that everyone believed: either you got lower inflation and higher unemployment or the reverse and that was it. But now I think there's a much more sophisticated view of that relationship and it differs.

MR. BLACK. We can use a long-run perfectly vertical Phillips curve and I wouldn't have any objection to that.

MR. BOEHNE. The truth is we don't know. We can have our biases but we don't know.

CHAIRMAN GREENSPAN. Yes, that's about the best.

MR. BOEHNE. And what you have is an array from the most optimistic and least costly all the way over to something that would be fairly costly.

CHAIRMAN GREENSPAN. Yes. Also, I think in all of our minds is the thought that over the next five years we really believe in some way or by some means that there is going to be a recession. And that's going to be the period in which the price [improvement] occurs.

MR. BOEHNE. Right. But, with the exception of Lee here, probably few people would be willing to precipitate a recession to pull it off. But, if one occurred, we'd be willing to take advantage of it.

MR. HOSKINS. I never said I wanted to precipitate a recession. I object.

SPEAKER(?). That's why I said--

CHAIRMAN GREENSPAN. I think lunch is served.

END OF MEETING